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**UNITED STATES AGENCY FOR INTERNATIONAL DEVELOPMENT**

## **Small and Medium Enterprise Interventions and Gap Analysis**

# **FINAL REPORT**

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## Executive Summary

Small and medium enterprises (SMEs) are one of the foundations of developed economies. Unfortunately, they have been overlooked in Bosnia & Herzegovina (BiH), where traditionally the state took responsibility for job and wealth creation through large industrial combines and agricultural cooperatives. With the collapse of the state-employment model, BiH must now encourage SME growth in order to stimulate economic development.

An environment that supports and stimulates SMEs must have certain characteristics. From an SME perspective, the environment must permit sufficient revenues to cover costs and risks of doing business. In a healthy economy, costs and risks are kept low (with risks limited to market risks, not unpredictable government confiscations or interference) and revenues remain reasonable for businesses and consumers through competition. This depends, in part, on having an appropriate legal framework for commercial growth based on modern laws and responsive institutions that enforce commercial obligations, reduce unfair competition, and increase trade opportunities. The proper legal framework will also ensure that SMEs have improved access to the capital they need for investment and success. Yet they will also need business development services to enable them to understand and face the challenges before them.

### What do SMEs need in Bosnia?

According to SMEs, there are numerous barriers to their success in BiH. These include:<sup>1</sup>

- High start-up costs and complexities of registration
- High costs of inspections, licensing, permits (especially construction) and approvals
- High taxes (direct and indirect)
- High labor costs and restrictive labor policies
- Poor access to affordable capital
- Confusing, conflicting, and poorly disseminated laws and regulations
- Lack of land available for development and construction

These specific constraints indicate larger problems in the underlying framework for growth, with numerous gaps between what is needed and what is available. One of the primary problems is the lack of any articulated or comprehensive strategy for SME development or support. Neither government institutions nor donor agencies have developed such an approach in BiH. Although donors are working on various facets of the SME environment based on their different mandates, these individual interventions do not adhere to any comprehensive, overarching framework of SME needs in BiH. The World Bank's Poverty Reduction Strategy Program highlights numerous legal and institutional barriers to development, with clear, specific targets

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<sup>1</sup> SME observations and priorities are taken from *Analytical Report and Administrative and Regulatory Costs Survey for Bosnia and Herzegovina*, World Bank, April 2002; *Bosnia & Herzegovina, Commercial Legal Framework and Administrative Barriers to Investment*, Foreign Investment Advisory Service, March 2001 (the "FIAS Report"); *Doing Business in 2004, Bosnia & Herzegovina, Country Profile*, World Bank 2004; *Bosnia and Herzegovina Enterprise Policy Performance Assessment*, OECD, September 2003; and *Bulldozer Initiative, Phase I*, OHR (undated)

for reform, but this is not (nor was it designed to be) a comprehensive framework for SME growth.

### **A Strategic Starting Point: USAID's SME Intervention and Gap Analysis**

The United States Agency for International Development has commissioned this study and report as part of an initiative to develop a more effective strategic approach to meeting SME needs through donor program assistance. The SME Intervention and Gap Analysis task provided expert analysis through desk studies, interviews and comprehensive donor input through a roundtable to provide a basis for coordinated strategy and improved understanding among donors. The Roundtable, held in Sarajevo on April 6 and 7, 2004, assembled 143 participants representing 45 different SME-oriented donor projects. Local and foreign resident experts from the World Bank, SEED, EU, DfID, GTZ, SIDA, and USG (Embassy, Treasury and USAID) led 12 break-out groups to identify on-going gaps in the legal, financial, and business-support framework for SME growth.

Participants at the Roundtable validated, elucidated and expanded the preliminary expert gap analysis and provided input on priorities and linkages between the gaps through nine hours of group discussions. While this participatory gap analysis was an important result of the conference, participants felt strongly that the Roundtable had been invaluable in providing a context for interventions and program planning. A number of participants noted that the presentations and discussions provided a more comprehensive strategic framework with immediate impact for their existing and future work. Moreover, there was strong consensus that participants could and would use materials and contacts for better technical and strategic coordination and communication with other projects and donors.

The Roundtable provided substantial input for additional analysis. It also brought to light divergent viewpoints on the several topics. Participants debated whether there was a problem of entrepreneurial spirit in the country, whether banks were lending enough or too much, and the effectiveness of different approaches to reforms. These different perspectives were not based on a lack of statistics, but on different assumptions and vantage points that are difficult to address or identify without dialogue. The debates also highlighted the importance of events such as the Roundtable and the need for more of them. The participant debates, comments and conclusions have been captured in this Report to provide a thorough overview of needs and priorities for donor assistance in ensuring a more vibrant SME sector in BiH.

### **Summary Conclusions: A Great Need for Balance**

Costs, risks and revenues are out of balance for SMEs in BiH. As a result, businesses are having a hard time achieving the profitability they need to prosper. Costs of setting up and operating a business – including registration, taxes, labor, and inspections, among others – are much higher than international benchmarks,<sup>2</sup> and much too high to bear. Revenues are restricted by unfair competition and an underdeveloped trade regime. Risks related to commerce and investment are high because commercial agreements are not readily or reasonably enforceable, leading to higher costs of finance and lower access to capital, which in turn make profitability

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<sup>2</sup> See FIAS Report for comparative analysis of BiH with international standards.

more difficult. Together, these factors lower firm and country competitiveness, deepening the dependency of BiH on donor support.

The donor community is already extensively involved in providing technical and financial assistance to BiH to address these problems for a better SME environment. USAID has a number of programs underway that directly or indirectly address priority needs of SMEs in BiH, including legal reform, improved access to finance, and better business development services. USAID is also directly addressing issues of competitiveness through cluster initiatives. At the same time, DfID, the EU, GTZ, the World Bank and numerous others are targeting similar problems through national, regional and local initiatives. All of these efforts are necessary, but even together they are not yet sufficient.

Participants at the SME Intervention and Gap Analysis Roundtable identified numerous gaps related to specific areas and initiatives. They also concluded that there were a number of overarching themes affecting the balance of a wide range of individual initiatives. From this broad perspective, several priority issues emerged:

*Crushing Costs of Compliance.* The overlapping, redundant and unregulated regime of multi-level authorities for taxes, inspections, approvals and licenses is more than SMEs can bear. Interviews and surveys among SMEs (see footnote 1) indicate that these high cost, high risk, unnecessary government taxes and interventions are a principle reason for the high percentage of informal activity in the gray economy. Many entrepreneurs simply do not register in order to stay invisible to the authorities who impose these unbearable costs of being formal. Many donor programs are already addressing some of these issues, but coordinated, comprehensive strategic planning is needed.

*Enforcement of Commercial Obligations.* Banks and businesses run a high risk of non-payment because there is no culture of accountability in the marketplace. This is not just an issue of inefficient courts – which are being reformed – but of poor private sector practices in avoiding the need for court intervention and poor enforcement of judgments once courts finally rule. Of the three parts of this equation (private sector practices, court efficiency, and enforcement capacity), only court efficiency is being addressed effectively.

*Human Resource Development.* Skills and education in the SME sector are in great need of improvement to meet the standards of local productivity and regional competitiveness they require. Donor programs are an important source of potential improvement, but the projects are not going far enough. More resources are needed within each project for public education (to address historical gaps in understanding markets and business), practical training through on-the-job interaction, and curriculum development for institutions of higher learning to ensure more widespread ongoing use of the excellent materials being prepared within individual projects.

*Communication and Coordination.* Participants uniformly found that the donor community must improve its communication and coordination with each other and local counterparts to ensure maximum impact. The Roundtable was lauded as the first time many of the participants learned of many of the other players and projects in the country. They also noted the need to carry on similar large- and small-scale events

with local counterparts, including government and private sector stakeholders, bolstered by more regular, systematic communication. BiH needs a comprehensive strategy for SMEs, but one that includes input and buy-in of stakeholders through improved communication and coordination among all parties.

This Report addresses these and numerous other problems identified through the SME Intervention and Gap Analysis and Roundtable. Each of the sections following divides the issues by general and specific categories to provide analysis of the situation of SMEs for BiH today, including current donor assistance programs. The gaps that have been identified are prioritized in the order agreed upon by Roundtable participants and are followed by practical recommendations on how to address them for a greater impact on economic growth and development in Bosnia and Herzegovina through the SME sector.



## II. Overview, Conclusions and Priorities

### A. Overview

Small and medium enterprises (SMEs) employ two-thirds of the workforce of the European Union<sup>3</sup> and about 50% in the United States.<sup>4</sup> Despite their importance in the economies of developed countries, SMEs have been overlooked in Bosnia & Herzegovina (BiH), where traditionally the state took responsibility for job and wealth creation through large industrial combines and agricultural cooperatives. The collapse of the state-employment model now means that BiH must encourage SME growth in order to stimulate economic development.

What are SMEs? According to the European Union, micro, small and medium-sized enterprises are defined as:

- **Medium-sized enterprises** have fewer than 250 employees. Their annual turnover should not exceed 40 million euros or their annual balance-sheet total should be less than 27 million euros.
- **Small enterprises** have between 10 and 49 employees. They should have an annual turnover not exceeding 7 million euros or an annual balance-sheet total not exceeding 5 million euros.
- **Micro-enterprises** are enterprises that have fewer than 10 employees.<sup>5</sup>

This definition includes many of the state-owned enterprises (SOEs) in need of privatization as well as all start-up businesses in the country. In fact, it includes most of the economically productive actors in the BiH economy, representing a major portion of approximately 60,000 registered companies and an untold number of unregistered businesses in the gray economy. SMEs are important to the future of Bosnia and Herzegovina.

### Two Views of the World

SME development is a complex challenge involving numerous stakeholders in every sector of government and the economy. Improving the environment for SME growth has implications for business, foreign trade, education, tax revenues, employment regulations, and a host of other general and specialized areas. To meet the challenge requires clear direction toward properly defined goals. This raises a crucial issue: whose goals?

Governments rightfully see SMEs as an engine of growth that can reduce unemployment, increase foreign trade reserves through exports, and provide a base of tax revenues to support the government and its programs. Consequently, governments (and donors that assist them) often focus on achieving these and other macro-economic and social goals through the SME sector. They attempt to maximize revenues while encouraging employment and trade, thus maximizing other revenues such as export tariffs and employee pension fund contributions. These are appropriate goals for a government, but if the ultimate goal is to increase SME activity, SME needs – not government use of SMEs – must be the starting point.

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<sup>3</sup> [www.europa.eu.int/scadplus/leg/en/lvb/n26013.htm](http://www.europa.eu.int/scadplus/leg/en/lvb/n26013.htm)

<sup>4</sup> [www.sba.gov/advo/press/04-06.html](http://www.sba.gov/advo/press/04-06.html)

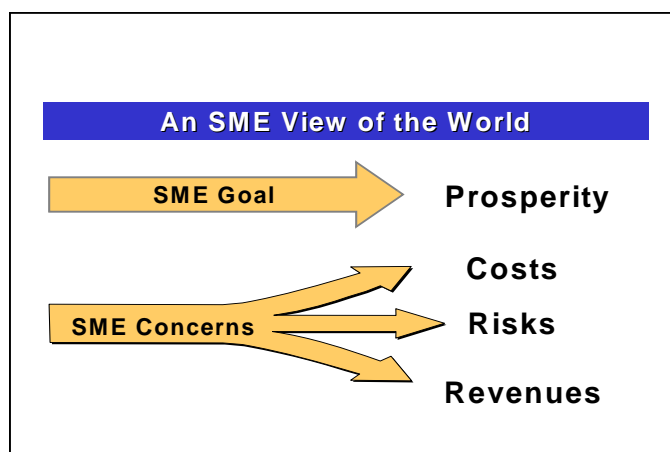
<sup>5</sup> [www.europa.eu.int/scadplus/leg/en/lvb/n26001.htm](http://www.europa.eu.int/scadplus/leg/en/lvb/n26001.htm)

SMEs see the world quite differently. They do not attempt to maximize employment, improve trade flows, or solve socio-economic problems. Instead, the principle goal of an SME is to produce enough income from business to meet costs and turn a reasonable profit. They need to make money. Individuals who start SMEs may also wish to achieve more grandiose social or charitable goals through their business, but they will fail if the business is not prosperous enough to survive.

In simple terms, SMEs seek profitability, and profitability depends entirely on their ability to balance costs, risks, and revenues that come from whatever field of endeavor they enter. They seek to lower costs, manage or eliminate risks, and maximize revenue opportunities. Although many SME owners may not know how to do a complete cost benefit analysis, or even a formal one, they will measure their costs and risks against their likely revenues with each decision they make. If they can earn enough, SMEs will grow and expand their business and investments. If not, they will switch into survival or subsistence mode, trying to only to maintain their achievements.

Each goal of government is analyzed by SMEs according to this balance. Government wants to increase employment; SMEs want to employ only those they need to support the business at a cost they can afford. If labor costs go down, they may employ more. If labor costs go up, they employ fewer. Taxes go in the cost side of the equation. Payment of taxes may bring benefits – such as improved roads or utilities, or permission to engage in certain activities – while

non-payment brings risk of penalties and punishment. When taxes are high, benefits low, and enforcement uncertain, most countries will suffer from rampant avoidance by SMEs (and all others) who find that tax payment undermines their competitive position and reduces their profitability.<sup>6</sup> If the goals of government depend on the health of the SME environment, then the proper strategic approach is enhance that environment on the basis of what SMEs need to prosper.



The analysis of each section in this report is based on how the particular area affects the profitability of the SME sector. SMEs frequently complain about the access to capital in BiH, but what they mean is *reasonable* access to *affordable* capital. For those who can pay the fees, afford the interest, and provide enough guarantees, there is no shortage of capital in BiH (or elsewhere, for that matter). Whether rates are reasonable is not an issue of whether interest is at 7%, 9% or 18%, but whether the investment of the funds can produce enough income to pay back the loan, with profit. Likewise, SMEs and their lawyers do not analyze the legal regime based on its inherent harmonies or proximity to European standards, but by how a law affects

<sup>6</sup>Many argue that tax payers should pay their taxes simply because it is the law, and we should obey the law. But tax laws are not moral laws; they are laws that support a state and the services it provides. When the state is seen as overpriced for the benefits received, the average tax payer will feel no compunction in evading taxes.

costs, risks and revenues. Business services and human resource development are costs, which, if incurred, can produce substantial revenue benefits.

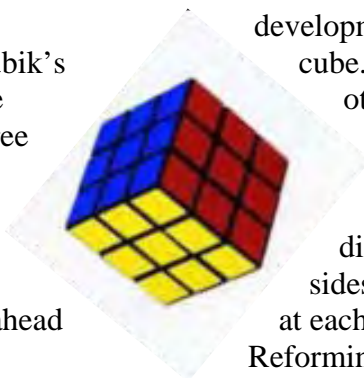
The analysis also applies this approach to those providing goods and services that SMEs need. One of the reasons that banks require high levels of collateral is that there is a high risk that the loan agreement cannot be enforced. Unless that risk is reduced, there will continue to be a high cost attached to it.

From a development perspective, donors normally seek to improve the SME environment in order to increase broad-based, market-oriented economic growth and development. It is not enough to provide useful services or better laws to achieve that, unless those laws and services affect the costs, risk, and revenue calculations of the target business population. Consequently, this report also seeks to determine how interventions can improve the ability of individual SMEs to achieve greater prosperity, whether by directly reducing their expenses through tax deductions, or indirectly by pooling resources in a business association that advocate changes in the legal environment. People respond to incentives, so donor interventions will be successful only if they provide or improve incentives that increase the likelihood of response in a way that supports development.

### **A Complex Balancing Act**

Development may require careful attention to the balance of costs, risks, and revenues for SMEs, but that is not the only balance to maintain. First, SMEs are not the only group in the country with interests that must be taken into account. Government has legitimate interests in taxing economic activity in order to provide services, or regulating certain industries to ensure public health and safety. Employees need a livable wage. Neighboring countries demand access to markets. Foreign investors require certain safeguards not needed by local investors. Each intervention has foreseeable and unforeseeable ripple affects, each potentially leading to the need for new interventions or adjustments.

The process of economic aligning the squares in a Rubik's the blue pieces together, the disarray. Even if two or three properly, there may be three. This is because impact on three two moves to affect all six to the entire cube, looking ahead impact and consequences. conflict, multi-ethnic society is Rubik's cube.



development has been compared to cube.<sup>7</sup> If you focus only on getting other colors may all end in sides come together problems on the remaining each move has an immediate dimensions, and it takes only sides. Success requires attention at each move to understand the Reforming the economy of a post-certainly no less complex than solving a

Secured transactions provide an excellent example. The components of the legal framework for loans that are secured with property involve more than a dozen laws. (See box on page \_\_\_\_.) These include the laws on obligations, enforcement, pledge

<sup>7</sup> Rubik's cube has 6 colored sides, each with 9 separate, movable pieces, thus 54 separate faces. There are thousands of possible combinations, but the correct solution to the puzzle is to arrange each color into its proper side. (Images from <http://jjorg.chem.unc.edu/personal/monroe/cube/rubikmove6.html> and [www.drjad.com/fad\\_facts/timeline.htm](http://www.drjad.com/fad_facts/timeline.htm).)

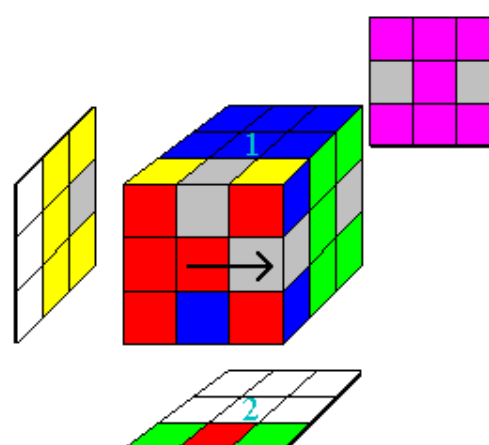
registry, leasing, bankruptcy and civil procedure. A change in the law on leasing, for instance, may promote leasing but eliminate certain secured loans. Changes in enforcement procedure may completely undermine all secured financing by making it too costly or risky to be commercially viable.

A change in these laws, however, does not only affect laws. In establishing a new system, numerous stakeholders will need to be informed. These include banks, micro-credit organizations, leasing companies, lawyers, notaries, judges, clerks, business associations, consumers and government officials, at the very minimum. Training programs that neglect a key group may result in very little impact, or even negative impact.

The cube model applies to other interests as well. It is true that high taxes can damage the competitiveness and viability of an SME, but a reduction in taxes leads to reduction in tax revenues for different levels of government. Which taxes need to be reduced? How will the authorities replace the lost revenues? It may be lower taxes will result in increased tax compliance, leading to greater revenue collection, but how long will it take? A tax reform cannot focus only on the SME aspect, yet SME reform must focus on the tax aspect.

There is currently no comprehensive model for economic reform and development, or even for reforming the SME business environment. To address problems, reformers tend to disaggregate the complex network of interlocking parts and fix one at a time. Each part is a separate Rubik's cube in its own right, which is often disaggregated into even smaller parts. For example, bankruptcy reform requires legal and institutional changes. The institutional changes include reforming the courts at various levels (process, management, and administration), as well as reforming the enforcement process, which involves other judicial and non-judicial personnel, as well as the private sector. As each project intervention focuses on its own area of specialized expertise, it is easy to forget that each reform affects some other part of the reform cube.

One purpose and result of the SME Intervention and Gap Analysis Roundtable was to bring as many relevant donors and implementers as available into the same room to examine the SME cube from all sides and improve understanding of how each activity affects the others. In so doing, it is possible to adjust strategies of existing programs while identifying gaps in the overall framework. The purpose of this report is to delineate and prioritize those gaps within the more comprehensive context, and to provide a unifying theme by focusing first on what matters to SMEs – costs, risks, and revenues.



## 2. Conclusions

Following this same analytical approach, it is possible to develop a number of important conclusions regarding the environment for SME growth and development. These can be seen in terms of costs, risks, and revenues as well.

a. *Costs.* The costs associated with doing business in Bosnia are crushing the formal sector and encouraging ongoing flight into the gray economy. SMEs must bear unnecessary expenses at every point in their life-cycle and value chain. A number of projects are making inroads on these expenses, but much work is still needed. Some of the primary excessive costs include:

Taxes. The level of direct and indirect taxes is far too high for the economy of BiH to bear. These include income, labor contributions, registration fees, license fees, customs tariffs, property transfer taxes and various charges, duties and fees by various local authorities. The introduction of VAT will result in reduction or elimination of some taxes, but the aggregate level of cost will still retard growth and economic development.

Start-up costs, regulatory burdens and inspections. The slow process and high fees for opening a company must be factored into business planning as sunk costs. These increase the level of start-up capital needed and lower overall profitability in the most crucial years of operation. Projects underway will hopefully bring BiH business registration requirements into line with international standards, but there will still be need to reform a panoply of other burdensome costs and requirements. Inspections, licenses, approvals and certifications all represent costs, all higher than necessary, and altogether they impose tremendous obstacles to successful investment.

Labor. Employment regulations are so over-reaching that they result in the reverse of their intended protections: they keep people from getting employed, not from getting terminated. In some industries, there are legal requirements for a minimum number of employees, without regard to the needs of the business. Employment regulations are completely divorced from the market realities of the workplace. Worse still, official requirements for labor contributions are so high that there is open and widespread avoidance, with employers misstating salaries to reduce pension contributions. Even some donor organizations have refused to pay the full amount of employee taxes required. Enforcement agents are reported to understand that no one can absorb the cost of full payment. Unless reformed, the gray market will continue to thrive (and probably grow), and industries that rely on seasonal and part-time labor will face serious constraints to success.

High collateral requirements for loans. Although there is some debate whether interest rates and bank fees are too high, there is no argument that collateral and guarantor requirements are excessive. This imposes indirect costs by unnecessarily tying up capital – including cash deposits for security – which might be needed to respond to market opportunities. The requirements are a direct result of risks, described below.

Education and training. The failure of the education system to produce sufficient graduates with skills needed for today's market place imposes a high cost on SMEs. They must either obtain additional training for their employees or limit their activities to lower-paying, lower-skilled industries. Public education may be free, but it is costly in light of the low quality.

b. *Risks.* The level of risk affecting SMEs in BiH is far too high. Most of the risk is non-market: that is, some risks do not come from the business in which SMEs engage, but the environment in which they do business. There are also significant market risks, some of which are affected by the legal and regulatory environment.

Donor efforts are underway for both types, but strong gaps still exist, and the result is slower economic development.

Enforcement. The single most important non-market risk for SMEs is the lack of predictable, affordable enforcement in the event of a commercial dispute. The courts are slow to issue judgments, but once they finally do, the judgment itself may not be enforceable, at least within a reasonable time frame at a reasonable cost. Without enforcement, commercial rights are no more than theories. Although courts are not the first resort in a commercial dispute, once needed, they are the last resort. Today, they function poorly at best.

Enforcement problems increase the risk of bankruptcy or other serious financial troubles. Occasionally this has a direct impact on SMEs – such as reducing their inability to enforce credits and contracts with their customers – but the greatest impact is indirect. Banks, MCOs leasing companies and other credit providers must manage this risk by increasing the costs of their products and services, increasing the collateral requirements, or both, or by simply refusing to grant credit. All of these have cost consequences for SMEs.

Current programs are needed, but not sufficient. They seek to reduce the risk of non-enforcement once a conflict comes to court. That is, they focus on the last resort. Yet there is much that SMEs can do on their own behalf to ensure payment well before courts are ever needed. Unfortunately, there is no work being done in that area. Instead, efforts can be compared a soccer team whose entire defense strategy focuses on training the goalie, instead of combining it with skills to keep the ball away from the goal in the first place. The rest of the team needs to be brought into this game.

Lack of affordable funding. The enforcement problems result in lower availability of affordable funding to meet ongoing needs of a business, especially in a crisis or new opportunity. If SMEs doubt they will be able to meet their funding needs, they will not pursue opportunities that require more funding, or they may not go into business at all. If they do get the funding, there is a risk that they will not be able to meet the terms and make a profit.

Unpredictable business environment. Business decisions are based on certain reasonable assumptions about the future based on existing conditions and the likelihood of change. A new law can create or destroy a business opportunity, but if there is no advance notice of the change, there is a higher risk of destruction and a lower likelihood of creation. The lawmaking process in BiH is highly unpredictable, with little public input to changes and even less public notice. Systems that require notice and comment allow SMEs to influence the direction of rule changes while preparing for changes they cannot stop. Such instability is a significant disincentive to foreign and domestic direct investment.

Poor access to market information. The lack of education and business support services means that SMEs in BiH often are unable to get the information they need to stay competitive. This is not just a matter of improving the supply of information through associations, press, or even internet portals. It also includes an understanding of how to use the information once obtained. The existing system of education and training is not providing such skills effectively.

c. *Revenues.* Revenues are, in part, simply the reverse side of costs. In a competitive market, the individual entrepreneur may not be able to vary the price of

products or services with costs, so a reduction in cost means an increase in revenues. But revenue potential is also affected by the size and nature of the market, which are in turn influenced by the legal and regulatory regime.

Unfair Competition. As a general rule, most businesses would love to limit their competition, allowing them to charge more for services and avoid the accountability for performance which competition creates. However, fair competition is both a cause and result of economic development, allowing each SME to compete against all others. Unfair competition, however, limits the ability of those affected to obtain the revenues they need by artificially lowering prices or reducing the size of the market. SMEs in BiH complain of both unfair and fair competition. Unfair competition is coming primarily from the informal economy, where costs are lower from non-compliance with taxes and other legal obligations. This can only be solved by resolving the cost issues raised above. Fair competition comes from several fronts, including trade and investment. Recent protests by public transit workers against the appearance of private bus company and recent support for breach of regional trade agreements in favor of BiH farmers suggests that much public education is needed before all competition issues can be dealt with properly.

Insufficient development of trade regime. Trade regimes have a tremendous impact on market size – and therefore revenues – by increasing access to export markets on competitive terms, thus increasing income potential for local producers. On the reverse side, it also increases competition with local producers and providers, but lowers costs of many industrial inputs and consumer goods, thus freeing those resources in the local economy. Currently, BiH is not a member of WTO and is thus missing numerous market-enhancing regulations (such as intellectual property protection) that can lead to greater revenue potential.

### **3. Cross-Cutting Issues and Linkages**

The Gap Analysis and Roundtable exposed a number of other critical issues and linkages with respect to donor interventions in the SME environment. These have implications for strategy and implementation. The linkages are relationships between different interventions and needs from the standpoint of impact on SMEs. Issues relate to gaps in project implementation by donors.

a. *Linkages.* The complex interplay among the dynamic components of SME development is daunting to identify and describe. Each area addressed in this report has a number of facets that are linked by considerations of sequencing, impact and importance. At higher level, this is also true. During breakout sessions of subject matter experts and plenary discussions of overarching themes, three key linkages appeared.

The primacy of the legal and regulatory environment. The baseline analysis for this report divided the SME environment into three parts: legal and regulatory environment; access to capital; and business support services and human resource development. Of these, access to capital is completely dependent on the legal and regulatory environment. Banks, MCOs, finance companies and even businesses provide affordable credit to others only when the costs and risks of doing so are manageable. This requires a stable, well balance legal and regulatory system. Complaints by SMEs about access to finance are actually complaints about symptoms

of deeper problems in the legal and institutional framework, problems that result in poor access.

Legal and regulatory issues are not so connected to human resource issues. Human resources can develop even in a poor legal environment, so they are not dependent on law. The return on any investment in human resources, however, is heavily influenced by the legal environment. The ability to obtain a well-paying job to compensate for investment in training and the capacity to produce enough revenues to pay for business consulting services both depend on the economic climate, which in turn depends on trade and investment, which in turn depends on access to capital, which at last depends on the legal and regulatory environment. If human resource development is ahead of legal development, then well trained individuals will often move to other countries where their skill levels can earn more. This is happening in BiH and all over the former Yugoslav republics. Such brain drain further weakens economic development and perpetuates the problem.

The quality of the legal and regulatory environment depends on many factors, but none more so than the type and quality of government. Even a brief comparison of the most and least developed countries of the world highlights a difference in government: responsive, democratic institutions produce responsive laws, fertile SME environments, and greater per capita wealth than the authoritarian, non-responsive regimes at the bottom of the list. For BiH, this has important implications.

A number of roundtable participants raised the issue of trust as a constraint to developing public-private partnerships. There is a reason for this: trust cannot be legislated, it can only be earned. The new governments of BiH have not yet earned the trust of the population.

For five hundred years, residents of this region have been under a series of authoritarian governments who were not committed to local interests. When freedom to form a new government finally came to Bosnia a few years ago, it was interrupted by an ugly power struggle that rapidly set one ethnic group against another, tearing the social fabric to shreds while engendering distrust. One result was distrust of government. To overcome this, government will have to initiate internal behavioral and structural reforms – such as responsive lawmaking and customer-oriented services – that earn the trust of the public. Donors need to be prepared to act as a partner in this process.

The primacy of enforcement. The secured transactions environment is the foundation for access to capital. As already noted, access to capital is essential for SME growth and development. However, the secured transactions environment is wholly dependent on enforcement, without which there are no rights, only risks.

Enforcement issues affect all areas of the SME value chain and all actors in the marketplace, including the government. The current legal system (which is undergoing dramatic change with donor support) was effectively designed to delay claims and enforcement. All over former Yugoslavia, courts perform badly, if at all. This is not an accident, and much work is needed to rectify this.



Courts are only one part of the problem of enforcement, however. The entire enforcement chain involves two additional segments: the private sector, which is responsible for diffusing default prior to court intervention, and the enforcement institutions, which are responsible for ensuring that judgments are carried out once a court settles a dispute. Today, no programs address private sector issues, and those addressing actual enforcement procedures are inadequate. Without proper enforcement, all donor efforts to improve the SME environment will be diminished.

The primacy of education. Entrepreneurs and investors need to understand a great deal about the world of business in order to be successful. If they wish to enter the marketplace, but do not have the skills they need, they will have to incur the costs of paying for additional education and training. This additional service will build upon the base of education and experience they take to the courses.

The formal educational system should provide skills and knowledge relevant to the marketplace. Today in BiH, this is not the case. Formal schooling is outdated in both content and pedagogical skills, graduating students who are not adequately prepared for the labor market. Once they have graduated, these students or their potential employers will have to pay to upgrade the skills and knowledge they would have gotten in a Northern European school system. This extra cost reduces SME competitiveness and profitability.

An overhaul of the existing school system does not immediately appear relevant to SME development. But it is. Until the basic education received provides the basic skills and knowledge needed to join the workforce of today's world, Bosnian businesses will bear the cost of reaching the minimum standards on their own, instead of investing the same funds to achieve excellence in the marketplace.

b. *Issues* This report is based on review of more than 120 project documents, 90 interviews (primarily with donors and implementers) and Roundtable input from 143 participants representing 45 different donor projects. This resource base provided a rare and useful comprehensive perspective on donor interventions and interactions. From these inputs, it was possible to identify a number of cross-cutting issues that did not related directly to SMEs, but instead to the work of donors with SMEs. Discussion of these issues at the Roundtable confirmed their significance to effective project implementation and impact.

Communication and Coordination. Roundtable participants uniformly agreed that there is insufficient communication regarding projects. This deficiency appeared at several levels. First, many participants commented that they were quite unaware of how many different projects were underway, including ones closely related to their own work. The matrix of SME interventions proved to be a valuable resource, because there has been a gap in communication between donors about what they are doing. This gap has led to conflicting and overlapping efforts at times, as well as lost opportunities for leveraging project assets for greater impact through collaboration. Second, many also noted that there was insufficient communication with stakeholders and counterparts, so that projects were not receiving the necessary strategic feedback that they needed. Conversely, stakeholders were not receiving the full potential benefits of interventions because much about the projects had not been effectively communicated.

There was also concern over coordination between and among donors and their projects. This coordination gap appeared at three levels:

- Policy: what needs to be done
- Strategic: how should it be done
- Executive: who should do what

All three of these problems were implicated in the area of legal and regulatory reform, where lack of coordination has led to several implementers working on different aspects of the interrelated laws in the area of secured transactions. Each donor organization had properly identified this field as a high priority for reform, but had done so separately, leading to an incomplete view of the field. Strategically, certain aspects (such as bankruptcy, obligations and leasing) should be treated as subsets of the overall framework, which can be reformed in stand-alone projects only if those projects are coordinated. Because they were not, several reforms undermined other reforms, without attention to proper sequencing and interrelations. The executive issue of who should do what has been affected by the strategic level: different implementers are presenting solutions based on different systems and models, without a system of determining whether a model is appropriate, or whether two different models can coexist. Decisions are needed on who should implement what kind of approach.

While no final solutions were offered for these problems, it was clear that the Roundtable had been successful in identifying the issues so that solutions could be developed. Strong demand was expressed for similar events in the future to ensure ongoing communication and coordination. The Roundtable also resulted in the formation of a donor coordination group for secured transactions, managed by the implementers, which has already been established.

Education and training. Problems of education and training were themes echoed in every discussion group. As opposed to the technical treatment of these subjects elsewhere in this report, the comments focused on the scope and breadth of training offered by projects. First, participants determined that many projects did not include enough people in their training programs – focusing on primary stakeholders but not necessarily others whose support and understanding was needed for more rapid adoption or sustainability. This was particularly noticeable with respect to public education, where there was a general consensus that projects were not committing sufficient resources to achieve a meaningful penetration of public understanding and support.

Second, a number of participants noted that the planned training was not deep enough, stopping short of necessary “how to” instruction, whether for participants or for trainers. Several implementers of legal projects specifically cited training programs only covered information about new laws, but not about how to apply or react to the laws. For example, court enforcement agents will receive information about the pledge registry law, but not about how to seize or auction the property subject to the law. Numerous practical skills are needed – especially in market concepts like valuation – that are simply not being taught.

Greater inclusion of local counterparts. Several implementers observed that local counterparts – especially government counterparts – are only included in most programs at the implementation stage. Many of them learn how to implement by conducting workshops or participating in surveys, but they do not receive any practical training in policy development, strategic planning, or similar important functions. As a general rule, very few counterparts, even in leadership positions, understand how to move from idea to policy, from policy to strategy, from strategy to action plan, and from action plan to action. Yet the full range of project management skill is needed and available through the expatriate specialists staffing the projects. Such inclusion would also lead to greater trust, ownership, and implementation.

#### 4. Priorities

Roundtable participants were asked to prioritize gaps and interventions based on their experience and understanding of local needs. These findings are captured in the separate discussions in the body of the paper, where priorities have been set forth in the order named at the Roundtable. Input from the roundtable led to other, more general findings about cross-cutting priorities as well.

Reduce taxes while ensuring revenues. Various burdensome fees and indirect taxes must be reduced or eliminated to support SME growth (such as business registration fees, immovable property registration fees, and movable property registration fees). As a result, revenues for local government entities are likely to fall dramatically. For these local governments to support and survive the changes, they will have to understand the implications of these reforms and identify alternate sources of revenue. Assistance is needed to identify all of the projected changes that will impact governmental revenues at all levels and the target implementation dates, whether tax-based (e.g., VAT, personal income tax, property tax, etc.) or fee-based (registration fees, inspection fees, etc.). The challenge is to ensure that local governments support the SME-friendly reforms while ensuring reasonable adequate resources for the performance of essential government services.

Reduce inspections. The SME community has complained vigorously about the numbers of inspections they must undergo in the start-up and operation of their businesses, adding unnecessary and often unbearable costs that provide incentive for informal activity. Although several projects are dealing with some of these issues, current resources are not focused on country-wide implementation of changes. Technical assistance is needed to help public and private sector stakeholders work together to define, publicize and enforce the mandates of inspection authorities (construction, health, phytosanitary, and others) based on commercial reasonability.

Comprehensive SME strategy. Today, there is no comprehensive strategy at any government level for SME growth and development, so that reforms, projects and interventions are insufficiently coordinated, prioritized or targeted for maximum impact. The SME environment would greatly benefit from the improvement of existing joint SME strategy units at the state and entity level that would work to ensure harmonized approaches. These units would need substantial assistance in learning to develop strategies and to create and implement action plans, using fundamental skills in project design and management. Just as importantly, the units will need to establish formal systems for gathering extensive input and feedback from the SME community to ensure that the strategy actually meets the needs of SMEs

while also ensuring that SMEs understand the governments' limitations in meeting those needs. The approach should be one of partnership and active collaboration.

Formal, responsive legislative process. Roundtable participants agreed that there is a significant gap in lawmaking capacity at the state and entity levels, so that current reforms are not well harmonized and there is high dependency on donor input and initiative that is not leading to sustainable reform. BiH would benefit from the introduction of a formal lawmaking mechanism that coordinates lawmaking efforts and includes mandatory, transparent public notice of all proposed amendments with opportunity for input by the private sector. Unfortunately, very few private sector associations currently monitor legislative changes or understand how to analyze them, so that assistance is needed to enable associations and think tanks to comment effectively and even introduce changes. In other words, technical assistance is needed to ensure a self-sustaining system for lawmaking based on consensus and private-sector need.

### III. Methodology

This SME Interventions and Gap Analysis was commissioned by USAID/Sarajevo to provide a baseline for the Mission's support strategy for development of small and medium enterprises (SMEs) in Bosnia and Herzegovina (BiH), where entrepreneurial activity remains limited, poverty high, and growth stagnant. Multiple donor organizations, including USAID, are providing assistance to the governments of BiH through programs that affect business growth. To ensure that new projects compliment but do not replicate completed, planned or on-going business enabling interventions, USAID determined to identify these existing interventions and any areas of needed assistance that they do not address sufficiently as the strategic basis for ongoing support and new project development.

To accomplish this, USAID assembled a team of expatriate experts to analyze the current status of donor assistance in BiH against international standards for a supportive SME environment and the perceived needs of SMEs in BiH. The purpose was to identify "gaps" – disparities between international standards and BiH reality – analyze them, and determine priorities for addressing them through project interventions. As an essential part of the process, USAID also decided that the initial analysis should be presented to the donor community in BiH for discussion, validation and prioritization through a roundtable. With this input, the Gap Analysis team could then incorporate additional findings and observations for presentation in this final report.

In this analysis, "gaps" refer to the disparity between the current reality in BiH and international standards relative to legal and regulatory environment, banking and SME finance sector and SME support services.

#### Establishing Standards for Comparison

The first step in identifying the disparity between international standards and existing conditions is to establish the standards that will be used for analysis. An environment that supports and stimulates SMEs must have certain characteristics. From a straightforward SME standpoint, this means that the environment must permit sufficient revenues to cover costs and risks of doing business. In a healthy economy, costs and risks are kept low (with risks limited to market risks, not unpredictable government confiscations or interference) and revenues remain reasonable for businesses and consumers through competition.

No single set of comprehensive standards has been developed for assessing the quality of the environment for SMEs. However, a number of organizations have established various indicators for evaluating different aspects of the environment. According to the global benchmarks of the Foreign Investment Advisory Service (FIAS), administrative barriers should be no more costly than those found in developed economies, so that a business can register, start operations, employ sufficient laborers and continue operations without undue expense.<sup>8</sup>

The environment must also provide an appropriate legal framework for growth. FIAS and USAID recognize that the commercial legal and regulatory environment requires a certain baseline of commercial laws along with development of implementing (public-sector) institutions and supporting (private-sector) institutions for sustainable

<sup>8</sup> See Bosnia & Herzegovina, *Commercial Legal Framework and Administrative Barriers to Investment*, Foreign Investment Advisory Service, March 2001 (the "FIAS Report").

development to ensue. These include laws relating to bankruptcy, companies, competition, contract, direct investment, real property, secured transactions and trade, as well as crucial institutions such as courts.<sup>9</sup>

In addition, Europe has developed basic standards for SME development in the area of business support and development services as well as government strategy. The European Charter for Small Businesses<sup>10</sup> and the Bologna Charter on SME Policies set forth a number of requirements for better training, education, access to information, and business development services.

## Preliminary Analysis

Synthesizing these international standards into an analytical framework, the Gap Analysis team structured the research and analysis into three main topics:

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- Legal and Regulatory Barriers to SME Growth
- Access to Capital
- Business Development Services

For the preliminary analysis, the team used a combination of research and interviews. Over the course of three weeks, they analyzed more than 120 documents and reports produced by the donor community over the past few years regarding projects affecting the SME environment. In addition, they conducted more than 90 in-depth interviews with donors, implementers and local counterparts to validate, update, and augment information gleaned from the reports.

In identifying gaps between international standards and project interventions, the team applied two standards:

1. Project interventions for SME development must be market-oriented or they impede the development of the marketplace and compromise sustainability of new entrepreneurial efforts.
2. An assessment of SME development gaps must be SME-centric. The supply of technical assistance, reform efforts, and business services provided through project interventions must first correlate to demonstrated customer demand, and then donor programs can respond to those demands.

Interviews and research also provided important insights into the perceived needs of the SMEs themselves,<sup>11</sup> allowing the team to compare project interventions with SME priorities. The SMEs' comments provided a basis for demand-driven prioritization, as well as a basis for analyzing perceptions and understanding by the SMEs of the problems facing them. For example, SMEs complained of problems with competition, but not necessarily with *unfair* competition: in one report, the

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<sup>9</sup> See, for example, *Commercial Law and Institutional Reform Diagnostic Assessment Report for Bulgaria*, USAID, January 2002, [www.usembassy.bg/prog/commercial\\_ass.html](http://www.usembassy.bg/prog/commercial_ass.html).

<sup>10</sup> [www.europa.eu.int/scadplus/leg/en/lvb/n26002.htm](http://www.europa.eu.int/scadplus/leg/en/lvb/n26002.htm)

<sup>11</sup> SME observations and priorities are taken from *Analytical Report and Administrative and Regulatory Costs Survey for Bosnia and Herzegovina*, World Bank, April 2002; FIAS Report (see note 4); *Doing Business in 2004, Bosnia & Herzegovina, Country Profile*, World Bank 2004; *Bosnia and Herzegovina Enterprise Policy Performance Assessment*, OECD, September 2003 ("OECD Assessment"); and *Bulldozer Initiative, Phase I*, OHR (undated)

respondent complained that the government was allowing competitors to set up in the same district, instead of *restricting* competition.<sup>12</sup>

## Briefing Paper and Matrix

Using this research and analysis, the Gap Analysis team prepared a preliminary agenda for the Roundtable, setting out potential topics for discussion over the course of the two day event. The agenda was then reviewed with USAID and finalized with twelve topics to be discussed through break-out groups. The team then prepared briefing papers on each of the topics, which provided a brief statement of the relevance of the topic to SMEs, the current situation in BiH (with a focus on donor involvements), and a list of gaps identified. No recommendations or priorities were offered, allowing instead for Roundtable participants to provide such input. The briefing papers were then distributed to all invited participants prior to the Roundtable

For greater understanding of current donor involvement, the team also prepared a matrix of donor activities affecting SME growth. The matrix presented 66 donor projects with brief descriptions of activities, objectives, duration, budget, outputs, outcomes, expected impact and risks. These snapshots of SME development were presented to participants as background for the Roundtable, in order to focus the technical discussion on the overall process rather than the individual projects. The matrix also serves as a post-Roundtable reference – providing recipients with a better understanding of current interventions as donors plan their future activities.

## Roundtable

The Roundtable, held in Sarajevo on April 6 and 7, 2004, assembled 143 participants representing 45 different SME-oriented donor projects. Local and foreign resident experts from the World Bank, SEED, EU, DFID, GTZ, SIDA, and USG (Embassy, Treasury and USAID) led 12 break-out groups in identifying on-going gaps in the legal, financial, and business-support framework for SME growth. In addition to these, during the Roundtable international experts presented findings on tax and immovable property resulting from recent separate research projects.

During this two-day event, participants validated the gaps presented in the briefing materials and identified a number of additional SME needs through nine hours of group discussions. While this participatory gap analysis was an important result of the conference, participants felt strongly that the Roundtable had been invaluable in providing a context for interventions and program planning. A number of participants noted that the presentations and discussions provided a comprehensive strategic framework with immediate impact for their existing and future work. Moreover, there was strong consensus that participants could and would use materials and contacts for better technical and strategic coordination and communication with other projects and donors. Participants also agreed on the need to communicate better with public and private sector stakeholders to ensure local ownership, prioritization and implementation.

In short, the Roundtable established a common understanding among donors and implementers on strategic approaches and needs for SME development in Bosnia and Herzegovina.

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<sup>12</sup> OECD Assessment, p. 22.

## Final Report

The Gap Analysis team collected and analyzed the findings from the Roundtable to update, revise and expand the briefing papers into this final report. The analyses which follows incorporates observations made by Roundtable participants and prioritizes gaps and recommendations based on participant input. In addition, broad findings from the Roundtable have been captured and presented in the *Overview* section, while specific findings have been presented in the individual analyses that follow.



## IV. Legal and Regulatory Environment

SMEs must have a proper legal and regulatory environment in order to flourish. From a business standpoint, SMEs analyze the environment in terms of their ability to engage in profitable, productive business activity, not in terms of laws. To achieve prosperity, SMEs must capture sufficient revenues to cover costs, manage risks, and obtain a reasonable return on their investments. If these factors are out of balance, entrepreneurial activity is stifled, and many businesses opt for the informal sector where costs are sufficiently low to justify the inherent risks.

Law and regulation are tools for balancing costs, risks, and revenues. To support SMEs, the environment must minimize non-market risks through clear definition of commercial rights, enforcement of those rights, and stable systems for managing changes in law and regulations. It must also ensure that non-market costs of doing business in the formal sector – such as costs imposed by bureaucratic impediments – are low enough to be borne by SMEs without destroying profitability. Finally, the business environment must maximize the potential of SMEs to compete for sales revenues by regulating anti-competitive behavior and enlarging markets.

Imbalances can occur at several levels. The most obvious are those caused by laws and regulations that inhibit SME activity, such as unnecessarily complex registration requirements. Thus, the content (or lack of content) of laws can create constraints, which is the traditional focus of legal reform projects. How the constraints got into the law is actually a larger problem. The process of adopting laws and formulating regulations can mitigate risks of bad lawmaking and improve consensus on implementation. In simple terms, it is better to have bad laws and good process (which can be used to fix the laws) than good laws and bad process (which can repeal or undermine laws without warning). Implementation and enforcement of laws create cost and risk problems. Implementation normally flows from consensus in a lawmaking process that produces agreement; enforcement depends on the quality of the institutions with enforcement power. Where consensus is lacking, stakeholders must rely more heavily on enforcement institutions, normally at higher cost and risk.

The international donor community is actively engaged in reforming the legal and regulatory environment of BiH at all levels. On the risk side, numerous projects are improving the definition of commercial rights by improving laws affecting contracts, ownership, secured lending, bankruptcy, and real property, among others. Other projects ensure court enforcement of commercial contracts. Remaining gaps include lack of capacity on the part of BiH counterparts to develop policies and implement laws, regulations, and policies at the level where SMEs operate. There are no meaningful, mandatory formal mechanisms for input by SMEs, nor a standardized system of impact assessments. In addition, planned education and training of stakeholders appear insufficient for the extensive changes underway.

On the cost side, donor assistance is rationalizing and reducing costs related to formal activity. These activities include simplification of various requirements for licensing and approvals, removal of unnecessary delays and complexities in company registration, and improving the transfer or creation of rights in property. In addition, efforts are underway to rationalize and decrease direct and indirect taxes. Despite a number of significant successes, a gap exists in planned replication of these reforms throughout the country.

The trade and competition regimes greatly affect revenues for SMEs. Unfortunately, much of the planned work in trade (especially with respect to WTO accession and EU integration) has been delayed pending resumption of bi-lateral trade agreements between BiH and its neighbors (which BiH unilaterally suspended to protect earlier this year to protect local producers from imports.). Competition issues take two forms. First, monopolies in the utilities have resulted in burdensome pricing regimes. The BiH governments need to address this through privatization, restructuring and better regulation. Second, unfair price competition from the informal sector undermines the ability of formal SMEs to attain necessary revenue levels. The solution is more complex than simply enforcement of regulations, because the excessive cost of doing business in the formal sector continues to compel informal activity as a survival strategy.

The analyses below cover current efforts and gaps in more detail for several discrete areas: (1) business registration; (2) certifications, approvals and inspections; (3) bankruptcy; (4) secured transaction environment; (5) tax and (6) trade, competition and labor.

## A. Business Registration

Registration of a business allows business owners to enjoy the protections normally inherent in operating within the legal system, including access to courts, licensing and permits, protection from unfair competition, and various other benefits offered to formal actors. For SMEs, the fees and complexities of registration are sunk costs that will need to be recovered through long-term profitable activity. If the process is too complex, business owners lose time better spent in generating income. If these costs are too high, however, entrepreneurs either forego new business or pursue it through the informal economy. If registration increases risks – by making a company the target of unwarranted inspections, for example – many businesses will also opt for the informal economy.

From a government perspective, registration is vital for taxation and regulation of business activity. A well-functioning system also permits statistical analysis for setting policies, determining revenue collections, and monitoring economic trends. While SMEs do not necessarily care about these issues directly, they do care about improvement of government services affected by registration (such as policymaking or prosecution of informal activity).

### Current Situation in BiH

BiH suffers from an overly complex system of registration, with fragmented laws, redundant fees and confusing filing requirements. FIAS has determined that the simple act of initial registration involves least 15 separate steps and generally lasts for more than 70 days with official costs ranging from approximately \$100 to \$1000.<sup>13</sup> The process involves numerous institutions, including the public prosecutor, tax authorities, various levels of the governments, and the utility companies. All of these institutions create delays, and many can levy various direct or indirect taxes. In some jurisdictions, it is even necessary to get an official certificate of sanity and physical health before you can register a business.

The system represents an unplanned growth of local and national requirements based in part on the need for government revenues. In more developed economies, registration tends to be designed to facilitate business activity by applying rapid registration (often in two days or less) with a minimum of steps, and to charge on a cost-recovery basis. In BiH, there is no national strategic framework for rationalizing costs in relation to business needs. Instead, competing authorities require redundant forms and levy fees with each form. It is not surprising that, according to OECD,<sup>14</sup> World Bank<sup>15</sup> and FIAS<sup>16</sup> business surveys, SMEs perceive the registration regime as a significant obstacle to doing business profitably: almost 50% describe it as a major or severe obstacle.<sup>17</sup>

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<sup>13</sup> Registration in Mostar costs KM 155, in Sarajevo KM 405, and in the RS KM 600, or KM 1600 entities involved in foreign trade. *FIAS Report*, pp. 41-51.

<sup>14</sup> *Bosnia and Herzegovina Enterprise Policy Performance Assessment*, OECD, September 2003 (“OECD Assessment”), p 22.

<sup>15</sup> *Analytical Report and Administrative and Regulatory Costs Survey for Bosnia and Herzegovina*, World Bank, April 2002 (“ARCs Report”), p. 12.

<sup>16</sup> *FIAS Report*, pp. 52-54

<sup>17</sup> ARCs Report, page 12.

Registration fees and complexities are not the only costs affecting formal businesses. SMEs complain that registration exposes them to various costly inspections at start-up and thereafter. Some have said registration turns a business into an identifiable target for a range of government officials seeking income. This exposure to unnecessary payments together with the high cost of registration drives many businesses to operate in the “shadow economy” without registering or to invest in neighboring countries instead of BiH. In either case, the government loses revenues while the quantity of local investment is reduced. Lower costs (and fewer inspections) would lead to greater registration, greater tax revenues, and greater economic growth.

Currently, DfID is leading efforts to simplify the inefficient, burdensome business registration system by replacing it with a streamlined procedure. The World Bank supports this work through its business environment adjustment credit (BAC), which conditions some fiscal support on the adoption of a simplified registration procedure. The target is no more than seven steps, taking between seven and fifteen days.

The DfID project is addressing the fragmentation of the legal framework by creating a state-level framework law, drafting entity legislation, and redesigning the court registration process as a one-stop-shop activity for limited liability companies and joint stock companies. The new process will utilize standardized forms of national application, simultaneous registration on a nationwide basis, and multiple types of registration (such as business, tax, and statistical offices) in no more than five days through visiting a single registration office. Registration of sole proprietorships and general partnerships, however, falls under the jurisdiction of municipalities and is not directly covered by this project.

Introduction and implementation of the new system have been delayed beyond original timeframes due to various consultative debates. In the meantime, DfID has harmonized the new registration law with other ancillary legislation. This included separation of licensing requirements from registration. For example, a business may register without first obtaining licenses; and even licensing requirements have been reduced. DfID predicts that the new procedures should be in place by the end of 2004 (after installation of necessary software, equipment and training to the government counterparts).

Finally, although registration for companies has remained in the courts,<sup>18</sup> DfID’s project reduces judicial involvement to expedite business registration. Courts will be required by law to approve any application in which the computer-generated form and attached documents of incorporation meet legally established criteria in terms of form and content; in those cases courts cannot request additional documents or ask for background checks. Registration information will be computerized, as well. Once municipalities are also brought on line (through other projects), information on sole proprietors and unlimited partnerships can be integrated into national database of registered businesses.

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<sup>18</sup> International best practices have consistently removed the registration offices from the courts, recognizing that registration is a ministerial act, not a judicial one. (*See FIAS Report*, pp. 53, 56.) This would be preferable for BiH as well, but political sensitivities are such that local counterparts are not prepared for so dramatic a move. This topic should be revisited in five to ten years, once it becomes clear to stakeholders that they do not need court involvement. For now, the proposed changes represent dramatic improvement, even if they stay in the courts.

## Gaps

Gaps in current and planned interventions occur in three areas: law, education, and financing. Law is the highest priority because it is the linchpin for reducing costs and a pre-requisite for designing appropriate education programs based on the law.

Ongoing Legal and Regulatory Gaps. The proposed new laws, once adopted, will be a substantial improvement over the existing system, but will still not fully address registration of sole proprietorships, general partnerships or agricultural enterprises: proprietors and partners register with municipalities, and farmers are not covered at all new system. For farmers, whose activities cannot be properly registered, this creates difficulties in obtaining loans. Needs of agricultural SMEs should be expressly addressed through amendment of existing legislation.

In addition, the framework laws are not fully supported by implementing regulations and procedures. Additional work is needed to delineate in practical terms the different procedures and requirements for different types of registration; for example, limited liability companies will register in courts under court procedures while sole proprietors are handled by municipalities through administrative procedures. Reforms must therefore be expanded to ensure that all entities involved in business registration undergo needed reforms.

Finally, labor regulations have an impact on registration. Employment laws have required that certain types of business hire a minimum number of employees, despite the fact that start-ups do not have the resources to meet these government-mandated targets. This demonstrates a fundamental lack of understanding by lawmakers of the reality of market economics and business activity. Trying to force job creation through artificial quotas simply creates another reason for SMEs to go into the informal sector. The law must be changed to close the gap between regulation and economic reality.

Education and Training. Current project plans, when completed, will result in installation of registry equipment and software. Effective completion of these reforms, however, will require training of registry personnel, training of lawyers and notaries, public education on new rights and procedures, and monitoring to ensure adoption and implementation. Unfortunately, local stakeholders do not have sufficient understanding or resources to meet these needs.

**Training in specific new laws** and procedures will be needed among various stakeholders. As new laws are passed, experience to date suggests that a great deal of explanatory material and detailed regulations will be needed to ensure uniform application of the laws. SMEs complain that framework laws tend to be interpreted in different ways by different authorities, leading to overlaps, contradictions and disharmony, as well as inconsistency with EU directives. Education and practical materials (such as handbooks on procedures) will be needed for registrars, notaries, lawyers, court officials and the general public to ensure sustainability.

Roundtable participants noted that experience elsewhere suggests that a significant number of clerks and officials responsible for implementing changes will resist implementation either from ignorance (not properly informed) or rent-seeking traditions. It is therefore important to equip businesses through **public education and**

**outreach** to ensure that they know their rights and thus can resist inappropriate efforts by public servants to impose discontinued procedures or assess unallowable fees. Merely educating the public servants is not sufficient. Planned interventions do not currently envisage user-side education of this sort.

Public education should include more than the new rights and procedures. Many SMEs in BiH find that many officials and even fellow citizens are biased against SMEs because they do not understand their importance or function in the economy. Under the Yugoslav regime, large government-owned industrial combines were responsible for providing employment, and smaller, independent operations were inherently suspect. Negative attitudes tend to influence behavior of officials, many of whom expect large investors to replace the old combines and fulfill the old roles of SOEs. They need to understand that SMEs are the lifeblood of a healthy, developed economy, and are the foundation for larger-scale investments. Such understanding is essential in moving officials toward a public service mentality instead of the current control mentality.

Donors and SME representatives complain that all of these gaps and issues point to a more fundamental gap: that the government has not elaborated or disseminated any overall strategy for developing the SME sector. Such a strategy could serve as a focal point for reforms intended to increase not only registration but also the incidence of SME activity in BiH.

Financing Government Services. Pricing for business registration services should be sufficient to cover the cost of providing the services yet not be so high as to discourage registration. Current costs are prohibitive for smaller ventures in part because the system has been seen as a “cash cow” for raising government revenues. The prospect of lost revenues is a barrier to government acceptance and implementation of proposed fee reductions. Theoretically, increased registrations at a lower rate could produce more revenues than are currently being collected at exorbitant rates, but no studies have established a satisfactory case for this.

Even if governments accept the reduced revenues for registration, unless revenue needs are met through increased volume (and reduced cost of processing), relevant authorities will seek to collect the lost revenues elsewhere, and thus move the burden from the registration event to some other fee or tax. There is an analytical gap in understanding the impact of changes on revenues, and a strategic gap for ensuring that reasonable revenues are captured elsewhere. These fee and taxation issues represent serious cost impediments to SMEs and must be thoroughly be addressed at other levels – such as inspections and licensing – in order to ensure enduring changes. (For further discussion, see section \_\_ Taxation and \_\_ Licensing, Certifications and Approvals, below.)

The gaps described have a certain logic to them. Lack of understanding of the importance of SMEs leads to poor attention to SME needs and unnecessary barriers to their existence, reflected in poor laws, high costs, and complex procedures for registration. These barriers increase costs of registration, which in turn increase the likelihood and incidence of informal sector activity, instead of formal registration. Informal activity reduces the tax base and revenues, leading to increased pressure for

revenues from the formal sector, and again driving SMEs out of the formal economy into the “shadow economy.”

There are several points of intervention. Laws (resulting in reduced cost structures) can serve as a starting place, but only if there is education to accompany them so that policymakers and officials understand the needed changes, public servants understand the new procedures, and users know and insist upon their rights. Improved understanding could precede legal changes, but the two can also be pursued in parallel, using the legal reform processing as a training and education exercise. In the end, however, improving registration is necessary but not sufficient: additional burdens of inspections, approvals, licenses, taxes and labor regulations are serious constraints upon private sector growth and development.

## Recommendations

1. Complete the reforms underway. Due to delays beyond the manageable interests of donors, current reform work is not yet complete. The new state-level laws that provide the framework for improved registration have not yet been adopted and corollary entity laws have not been drafted. Until the framework is adopted, no software or equipment can be designed, provided or installed. It is thus of utmost priority that the appropriate authorities at state and entity level approve the new system. Once approved, the new processes and equipment can be introduced.
2. Expand the reforms. Additional legal amendments are needed to capture agricultural activities within the formal SME framework. Likewise, the current reforms do not cover registration of sole proprietors, traders, and partnerships, who comprise a significant segment of small investments. Likewise, labor laws need to be amended to eliminate mandatory hiring requirements for SMEs: economic imperative determine the size of an enterprise.
3. Provide comprehensive training and education. Training in support of the changes can begin as soon as the laws are passed. The priority need is for training in how to start a company, but it is also important to include information on deregistration when operations cease. Topical training and education should cover the following groups and institutions:
  - a. *Changes in Laws.* Various stakeholders will interpret and apply the new laws, and need to do so consistently. Appropriate materials should be used for and made available to:
    1. Registration judges
    2. Registration clerks
    3. Lawyers
    4. Notaries
    5. Loan officers
    6. Business consultants
    7. Consumer organizations (NGOs, ombudsman units of government)
    8. Business associations
    9. Donor organizations and implementers supporting SME development

b. *Changes in Procedures.* Those who assist with registration will need to know more than the law, they will need practical guidance on how the new law operates and what new procedures are in place. Different information is needed for different stakeholders, and should be tailored according to those needs:

10. For clerks and judges, a practical handbook and annotated guide to the law and procedures.
11. For lawyers, notaries, loan officers, and business consultants, practical guides for assisting SMEs with the registration process (including standard forms, annotated laws, and any government directives or interpretations) explaining how to assist clients in complying with the new procedures.
12. For business associations, consumer organizations and donors, a “bill of rights” informing SMEs of the new procedures, how to comply, and how and where to complain or appeal if they encounter obstacles. Ideally, this information, including necessary forms, should be available at every registration office.

a. *Public Education.* A national program of public education is needed on the role and importance of SMEs in the economy. Many officials and potential investors are still waiting for the resurrection of large enterprises to provide jobs, something that will not happen. Once there has been substantial reduction in the costs and risks of formal sector activity, another program is needed to identify the benefits of formal activity for the individual SME and the economy as a whole.

13. Tax and Revenue Rationalization. As noted below in section , Taxation, the various government levels need to ensure sufficient funding for the services they provide without crushing private enterprise under an overly burdensome tax regime. Reduction in registration fees must be offset by reductions in costs to government or increases in revenues through increased volume or other taxes. Otherwise, the burdens will simply be shifted from registration to another point of collection.



## B. Certifications, Approvals and Inspections

Government has a legitimate interest in bringing commercial activity into the formal sector. The government must ensure a sufficient tax base and regulate certain activities, such as those affecting safety and public health. This requires approvals and inspections to ensure compliance with laws and regulations. From the SME perspective, every requirement imposes costs that affect profitability and potential for success. BiH must build an SME business environment on rational costs that can be readily absorbed by the market; otherwise, SMEs will go out of business or move operations into the informal sector.

To promote SME growth, government must find a way to control, simplify and rationalize these formal burdens to allow businesses to prosper and compete effectively. Government must enforce relevant regulations equitably to lower the risk of competitors evading the law to obtain unfair (and illegal) advantages.

The fulcrum for balancing public and private sector interests is consensus. When the private sector does not respect government claims for revenues or involvement in regulation, resistance increases, and the government must rely increasingly on force rather than compliance. When the burdens are considered legitimate by the private sector, business will actually support reasonable compliance and enforcement efforts. Such consensus depends on a shared understanding of government's role and mandate, and understanding depends on dialogue. Where these are missing, costs to business and government rise as resources are unnecessarily allocated to avoidance and enforcement efforts.

### Current Situation in BiH

SMEs face significant barriers in the form of licenses, approvals and inspections, whether they are establishing or expanding their businesses. The situation is complicated because numerous jurisdictions have overlapping authority over these matters, including municipality, canton, entity and state.<sup>19</sup> Donors and stakeholders have complained that the multiple inspection and approval authorities lack a clear mandate as to the role, purpose and frequency of inspections.

The World Bank estimates that the informal sector accounts for at least 36 % of total employment in Bosnia & Herzegovina.<sup>20</sup> It is fair to assume that a large number of informal enterprises were driven to the informal sector by the excessive burdens of formal activity. These excesses also undermine respect for government.

The World Bank and SIDA are reviewing and reforming the inspection regime. The World Bank recently conducted a national study of the numerous inspections and approvals through an entity-level inventory of all inspectorates and their mandates. The World Bank and SIDA are also working to streamline and harmonize the operations of these various inspectorates, establish standards of conduct for inspectors and re-engineer the process to become more business-friendly. New processes should

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<sup>19</sup> OECD Assessment, p. 42.

<sup>20</sup> World Bank Report No. 24889-BIH, *Labor Market in the Postwar Bosnia and Herzegovina: How to Encourage Businesses to Create Jobs and Increase Worker Mobility*. November 4, 2002, p. 45.

be in place by the end of 2004. (This work does not include tax and customs inspections, which are being addressed by the EU.) This work will produce a Code of Conduct for inspectors along with training in that Code and proper inspection procedures.

In addition, this intervention will result in:

- Justification, revision, or elimination of burdensome regulations
- Rationalized mandates of inspectorates operating at Entity and sub-Entity levels
- Streamlined inspection organizations
- Clear and public mandates of the inspectorates and inspectors
- Rational, planned inspection schedules
- Standard forms and guidelines
- Reduced number of inspector days spent in any business in any given year, unless there is a criminal/wrongful activity underway
- Basic training of inspectors

Redundant inspectorates are not the only redundancy problem. SMEs must submit various forms and applications for approvals to different offices at different levels of government, instead of having a streamlined process that minimizes steps and points of contact. EU, OSF, Swedish, Swiss and USAID projects are working to establish “one-stop shops” for various registrations and approvals from municipal level authorities. The goal is to rationalize and simplify processes for approvals by eliminating steps and consolidating authorities to reduce the burden on business.

One-stop shops will reduce the time and money spent by SMEs in obtaining approvals, and will also reduce unnecessary government expense on these procedures by eliminating redundant jobs and facilities. Project implementers together projects hope to establish successful models in 60-70 municipalities that can thereafter be replicated in other municipalities.

In addition to burdensome inspections and multiple application points, quality certification is a problem for BiH exporters. The sector is highly fragmented, following partially updated standards from the former Yugoslavia. The EU is helping to establish a standardization institute at the state level, which is a requirement under the Stabilization and Association Process for eventual EU integration. GTZ and USAID are working to introduce quality certificates in certain industries. Veterinary services are on the EU agenda, along with certification for export of animal products. CAFAO is engaged in improving customs services as well, to reduce costs and delays in the import and export process.

The Bulldozer Initiative of the OHR is targeting a number of these barriers, including construction permits, in response to input from stakeholders and donors. The approach is to identify high priority, short-term interventions that can have an immediate impact. This initiative is stimulating interest in public/private partnerships in problem solving while providing a model for promoting priority reforms. Another serious set of costs for SMEs is imposed by the tax system. The problem begins with the complex institutional set up in the country, which has led to a plethora of tax rates and tax bases, causing confusion and uncertainty among businesspersons who cannot be sure what their requirements are or whether they have fulfilled them.

The uncoordinated and poorly designed tax policies impose very heavy burdens on labor and business that distorts economic decision making. It is generally accepted even by tax enforcement authorities that no one can (or should) pay all of the taxes imposed and maintain a profitable enterprise. Consequently, there is rampant tax evasion with government complicity, for few enforcement authorities require full compliance. (Tax issues are more thoroughly discussed in Section IV — *Taxation*.)

The EU and USAID are addressing tax issues through several projects that focus primarily on problems of tax administration. These interventions are improving the quality of tax collection services, transparency of rules, and treatment of tax payers. Plans are underway for elimination of some of the current taxes and replacing these with VAT, starting in July, but there is not yet a comprehensive program to address rates and policies.

## Gaps

Many of the gaps identified by studies and Roundtable participants relate to a lack of shared agreement between the private sector and government on the mandate of those inspecting, approving, licensing and certifying. Other reform needs flow directly from this lack of defined mandates, making it the number one priority for intervention. Standards for awarding approval to applicants are not always transparent or even stated. Without appropriate, defined parameters, it is not possible to hold officials accountable for their action (or inaction), even if there is a mechanism for appealing decisions. It is not even clear who has authority over what areas. Ascertaining clear parameters is therefore the next priority. These two gaps lead to a third: the need to establish clear, enforceable rights for SMEs – based on those clear parameters –with regard to inspections, certificates and approvals. This has a direct impact on their costs and risks of doing business in BiH. Donors have a fourth priority as well in coordinating their efforts to ensure efficient and effective assistance.

*Consensus on roles and mandates.* There is little shared understanding between the public and private sectors or between the local and international communities regarding the purpose and role of government with respect to SMEs. Many stakeholders believe they have no voice; many officials have stated that they do not want or appreciate input.<sup>21</sup> This “soft” issue of behavioral change is generally addressed only through assumptions that it will occur as a result of practical interventions.

For centuries, the primary purpose of official power was to collect revenues for oneself and one’s superior through the sale of privileges, imposition of ever widening taxes, and collection of duties. Although the Yugoslav years changed the ideology somewhat, the goal of facilitating commerce has never replaced the practice of controlling commerce. Without realigning and redefining roles, rights, and responsibilities, it will be difficult to establish self-sustaining changes in the administrative regime affecting SMEs.

This has a significant impact on issues of corruption. Under an extraction model of government, it is arguable that sale of licenses and negotiation of individual tax payments represents appropriate exercise of authority. Although ideology has shifted

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<sup>21</sup> OECD Assessment, p. 24.

toward the new paradigm of facilitating enterprise, habits and expectations have been formed under the old regime. Effective (and much needed) reform of corrupt practices must be founded on a general agreement of what is unacceptable under the new role of government.

In addition to the broader consensus on roles, there is no clear understanding of how often inspections may be held, can be inspected, how long inspections can last, or even the standards for approval. These issues create unnecessary risks and uncertainty, as well as unnecessary costs for overly frequent inspections. The same uncertainty exists for a range of approvals.

The recent World Bank study will benchmark the existing regime at all levels, but does not address the issue of rationalizing mandates.

*Accountability and SME Rights.* As noted, without a clear mandate or parameters for inspectorates and other officials, it is not possible to hold officials accountable for their actions or clearly define the rights of SMEs. Even worse, SMEs do not generally know of any system for complaining about inappropriate actions or appealing decisions of these officials. This state of affairs undermines respect for government while damaging business activity. There seem to be no projects underway or planned to address the need for a system of complaints and appeals.<sup>22</sup>

*Coordinated, sufficient intervention.* A coordinated intervention is necessary to continue removing redundant and overlapping requirements of state and entity authorities, as well as excessive burdens at the cantonal and municipal levels. The overall cost and complexity makes it difficult for any one donor to address all of the needs in this area. Some individual municipalities like Brčko have succeeded with focused interventions. The Tuzla canton offers some useful models, but these types of models must be replicated throughout BiH. So far, approximately only half of the municipalities are targeted for donor interventions whether the remaining municipal and cantonal governments will be able to follow suit is not certain.

Inspection reform needs additional coordination. Currently, WB/SIDA and EU/CAFAO are operating separate projects that can leverage resources. Working together, they could reduce compliance burdens significantly. This must include transparent determination of the mandates of inspectors, preferably resulting in a “bill of rights” for businesses so that they can become part of the solution by knowing how to protect themselves from inappropriate inspections.

*“Full faith and credit.”* Attaining a single economic space requires that each of the BiH entities respect certifications and approvals granted by authorities in the other entity or district. Additional work is needed to ensure that there are uniform minimum standards that will be accepted at all levels of authority so that businesses from one entity do not face unnecessary new approval and inspection burdens when they do business across internal borders. This includes national consensus on quality standards as well as full national acceptance of permits and licenses. As noted under

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<sup>22</sup> There is a state level Ombudsman office which might provide some assistance. From an SME standpoint, however, this office is not sufficient for the magnitude of the tasks at hand.

*Accountability*, SMEs also need access to an administrative appeals body to protest any denial of national treatment.

## Recommendations

1. Define the Parameters. Accountability requires a clear definition of roles, responsibilities and obligations. Otherwise, it is not possible to determine accurately whether any rights are being breached. Working from the World Bank survey mentioned above, technical assistance is needed to identify who is exercising what authority over the SME business licensing, inspection, approval and certification processes. With this foundation, two related activities are needed:

- a. *Eliminate Redundancies*. Identify overlapping jurisdictions to eliminate duplicate requirements that have not been addressed by existing projects. This might include elimination of actual authorities or creation of uniform application forms that can be used for more than one approval request, among other solutions.
- b. *Standardize Fees*. FIAS reports that fees for construction permit approvals, among others, are not standardized.<sup>23</sup> Fees should be standardized and based on clear requirements. (For government revenue implications, see Section V E *Taxation*.)
- c. *Develop Written Mandates*. For each entity that issues licenses, approvals, or certificates, or which conducts inspections, create a written, publicly available mandate stating:

- Legal authority for involvement
- Nature of work to be performed
- Standards of compliance for applicants
- Standards of conduct for officials
- For inspections, limitations on inspection authority, such as:
  14. Permissible frequency of inspection
  15. Scope of inspection
  16. Maximum duration of inspection
- Schedules of fees, charges, and penalties
- Process for complaints and appeals

These recommendations can be approached on a topical basis, for example, defining parameters for all official interventions involved in construction permits or for business licensing. This activity should be combined with public service education – that is, training administrative personnel how to serve the public. It is possible that no single donor will be in a position to address these issues on a comprehensive national basis.

2. Accountability. Administrative accountability needs to be established on several levels. First, accountability is a function of transparency, so it is important to disseminate and distribute information on administrative mandates, described above. This information should be available at administrative offices of each administrative unit with approval and inspection authority, in municipal offices, courts, and other relevant public offices, as well as chambers of commerce and websites. Public

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<sup>23</sup> FIAS Report, p. 85.

education will be needed to ensure wide dissemination of this information, as well as education of the media.

Second, accountability requires appeal and enforcement. Those government agencies with the authority to hear appeals from administrative decisions or to respond to complaints regarding administrative actions should be identified and publicized in the information noted above. If appropriate appeals and enforcement mechanisms do not exist, it will be necessary to create them. Particular attention should be paid to ensure national recognition of certifications and approvals.

3. SME Rights. As a corollary to written mandates, a “bill of rights” should be prepared and disseminated so that SMEs understand their rights and the parameters of administrative actions affecting their business activities.

## C. Bankruptcy

Bankruptcy is a system for ensuring the equitable payment of debts when a debtor is no longer able to meet its commercial debt obligations, either by reorganizing or liquidating the debtor. For SMEs, bankruptcy provides certainty of assistance in collecting debts from troubled debtors and in meeting or relieving their own debt burdens should they become overextended. At another level, the bankruptcy system lowers the risk of non-payment, so that lenders are more willing to provide reasonable access to capital at affordable rates. In short, bankruptcy is a commercial tool for ensuring repayment of commercial debts.

In transition countries, bankruptcy regimes serve an additional function: to clean up defunct and ailing state-owned enterprises for privatization or liquidation. Normally, these SOEs are burdened by tremendous non-commercial debt (loans made for political or other reasons without regard to commercial viability) and high political costs that national leaders are reluctant to pay. The bankruptcy system thus becomes a means of attempting to settle political issues with economic consequences. Unfortunately, it has often also been a source of state-assisted fraud and theft in transition countries by combining crony privatization with debt “forgiveness” before establishing liability for violation of fraud or corporate governance standards of accountability or responsibility

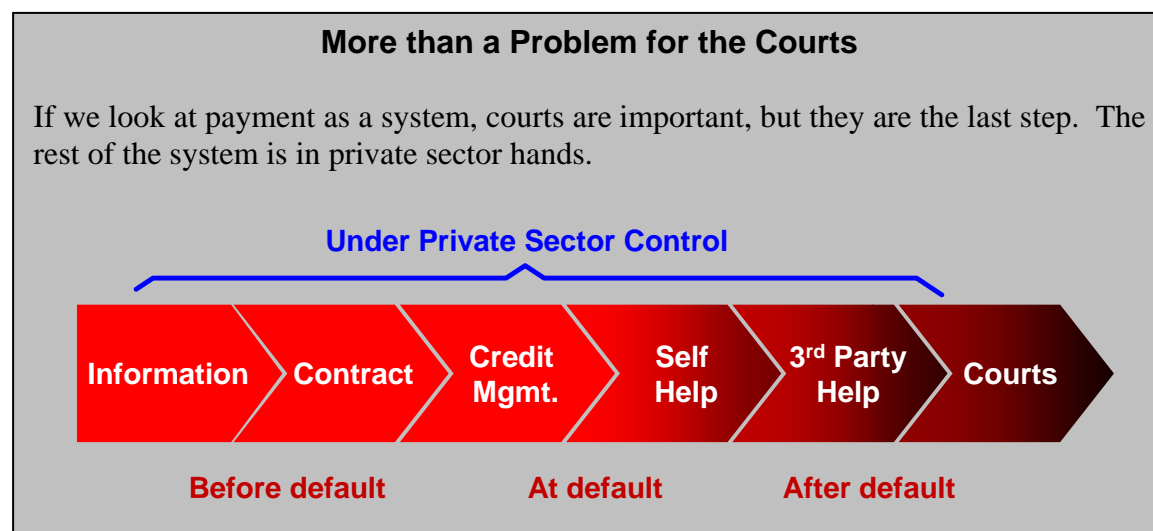
Commercial bankruptcy is best understood as part of the larger collection and enforcement system for commercial obligations. Bankruptcy design and practice are a part of the secured transaction regime through which creditors are perfected on the basis of a system of defined priorities. If the system fails to protect the reasonable expectations of secured creditors, creditors will raise the cost of capital or cease to provide certain types of lending rather than risk unnecessary losses.

Effective bankruptcy practice also requires prompt, reliable and inexpensive enforcement techniques. Where creditors have clear enforcement rights, they and their debtors must know that levy and execution procedures can and will be performed by competent enforcement officers, if they cannot seize the secured property themselves. Inefficiency of collection undermines the entire system, with negative impact on the entire regime for enforcement of commercial obligations.

Enforcement and bankruptcy are often analyzed merely as judicial issues, but the problems begin much earlier. From an SME perspective, the first priority is to *stay out of* bankruptcy – that is, to manage business, debts and receivables in such a way as to maintain financial health. Bankruptcy is a fallback position when business goes awry. Courts are a last resort, not a starting point.

The private sector has a powerful role to play in creating a culture of accountability that helps debtors to maintain payment discipline and avoid bankruptcy altogether. The private sector must therefore have tools other than the courts for improving payment performance. These include better use of credit information, the ability to draft clear contracts, registration of secured interests, management of payables and receivables, credit collection skills (including self-help remedies such as repossession) and alternative dispute resolution. Once debtors get into difficulty, they need access

to consultants and financial advisors who can help them turn their performance around and negotiate workouts. If they enter bankruptcy proceedings, they will need the same resources.



Of course, private rights often cannot be vindicated within the private sector alone. Some disputes need to be adjudicated. This can be done outside of the court system, through alternative dispute resolution, but if one party still refuses to comply, the parties must turn to the courts for assistance. In this regard, the courts have two roles: rendering judgments and enforcing the judgments rendered. If either is missing, the system will fail. Each involves separate and distinct systems. Rendering judgments requires efficient court proceedings. Executing them involves a system of enforcement officers, appraisers, auctioneers, and (for bankruptcy) trustees.

## Current Situation in BiH

Donor representatives report that a recent IMF mission characterized the economy of BiH as debt-ridden. High levels of SOE debt along with significant increases in consumer credit also raise concerns about eventual liquidity and payment problems. In short, BiH needs to have a bankruptcy system in place.

The donor community is addressing bankruptcy reform on several fronts. First, donors have begun to institute significant structural changes in the courts and the legal framework governing enforcement and bankruptcy. Specialized commercial divisions are being established at fifteen first instance courts in the Federation and RS. Both entities have enacted new bankruptcy laws and laws on enforcement procedure.<sup>24</sup> Furthermore, entities are enacting new Civil Procedure Codes with tighter timeframes, fewer hearings, and adversarial proceedings that eliminate the material truth standard. This is not merely an amendment to the existing system, but a *replacement* of the Yugoslav model with a Northern European model.

Second, several projects are working with local partners to implement these reforms. USAID is implementing training programs and providing resource materials for judges, lawyers, trustees and others on bankruptcy and liquidation, enforcement and

<sup>24</sup> The new bankruptcy laws, however, are at an implementation impasse because of pending amendments proposed by labor unions in the Federation.



other commercial laws. It is also conducting bankruptcy pilot cases involving state- and privately-owned enterprises, and introducing automated court administration procedures and practices into BiH's first and second instance courts.

USAID, the Council of Europe and BiH's entity-level judicial training centers are providing training and resource materials on civil procedure. Additionally, SEED and USAID are introducing mediation as an alternative to litigation. Together, these projects will reduce costs, delays, and uncertainties of dispute resolution. Other private sector tools for ensuring payment, however, are not being addressed. The focus is in court-based solutions.

The efforts underway directly address *commercial* bankruptcy law and practice. There seems to be a strong hope of settling the political issues of privatization as well by using the new courts to prepare SOEs for privatization. Very little privatization has taken place thus far in BiH, so that there is a substantial backlog of ailing SOEs that could be put into the new system.

## Gaps

The priority in bankruptcy reform is more practical than legislative. Sufficient laws are in place for a reasonable level of legal certainty, although additional legislative changes are needed. However, enforcement is highly problematic (as further noted in the section IV D, *Secured Transactions*) and is the highest priority for BiH because commercial activity depends on the ability of businesses to enforce commercial obligations.

Roundtable participants confirmed and identified a number of other priority gaps. First, there is a problem in the general understanding of bankruptcy among policymakers, judges, debtors and the general public. This adds to problems in enforcement. Second, limited capacity by the numerous stakeholders involved is a serious constraint on the effectiveness of the system. This affects another gap – the lack of out-of-court settlements as an alternative to full litigation. If the system is improved, there is another priority, which is how to use bankruptcy as a more effective tool for reorganization of troubled SMEs, rather than just liquidating them. As the basic system becomes more effective, a number of refinements are needed in the legal framework as well, but these can generally wait until the other issues are addressed.

### 1. *Enforcement.*

a. Operational problems in enforcement. Court reforms and bankruptcy implementation are weakened by insufficient attention given to practical reforms in the enforcement area. While some resources are dedicated to training appraisers and enforcement officers in new laws, there is a greater need for improved procedures and performance, including enhanced appraisal skills. Enforcement officers are not properly empowered to seize, warehouse and auction assets, whether movable or immovable. Unfortunately, improved cost and speed in rendering judgments is meaningless until the judgment itself can be enforced.

b. Education and Training. There is also an apparent gap in the education and training area. Experience elsewhere suggests that voluntary education is not sufficient to meet the level of need. While USAID and others will, in the short-term, provide significant training for judges, trustees, attorneys and others on

enforcement and bankruptcy matters, long-term judiciary education and training is necessary. Recent reforms introduced an improved system, not simply improved procedures. Judges have minimal continuing education requirements, and other professionals in the bankruptcy and enforcement regimes do not have any mandatory training. It may be necessary to establish mandatory requirements for continuing legal education programs or court certification programs.

c. The private sector role in enforcement. The availability of reliable commercial adjudications, enforcement actions and bankruptcy adjudications encourages the successful use of out-of-court remedies and “self-help.” However, there is no work underway to address the unrecognized private sector side of enforcement through any strategic program. There is a private, for-profit credit information agency, and possibly some consultants who can offer training in receivables management, but these are not linked to any donor assistance. Likewise, programs for improved contracting and collection techniques are not part of the framework. Such skills help SMEs and other creditors improve payment behavior by debtors, improve overall business management skills (and thus business profitability and viability), and enhance a culture of accountability.

2. *General understanding and political will.* Popular and professional understanding of bankruptcy is very poor at several levels, leading to a lack of support for the use of bankruptcy procedures. First, the general public and politicians see bankruptcy as something shameful, arising from impermissible failures, including moral failures.<sup>25</sup>

It is not understood as a preventive measure that enables debtors to restructure and become profitable; nor is it understood that market forces can lead to failure, leaving debtors in need of relief. Often, bankruptcy is seen as “getting away” with dishonesty or other failings.

Misunderstanding of market value also undermines the bankruptcy system. Political leaders and labor unions do not generally understand that the value of used, often-outdated equipment is very different from the purchase price. In BiH, the market for selling assets of a bankrupt company is quite limited, even for modern equipment. Hence, there is a tremendous gap between expected value and real value, leading to political and union intervention to stop what they see as unallowable under-valuation. In fact, their interference undervalues the bankrupt estate even more.

Unions also fail to understand the need for a cut-off of claims from employees. Numerous SOEs have large, redundant workforces, with many employees no longer working. Under the old system, work and payment were not related – employees could expect payment even when they no longer worked, or despite poor productivity, if the company reduced its revenues. Excessive claims from unions are today inflating the debt of troubled companies and leading to intractable delays.<sup>26</sup>

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<sup>25</sup> This is not surprising. In the 1960s, bankruptcy in the US was often accompanied by social stigma and shame, sometimes leading to suicide. More recently, bankruptcy in the former Soviet Union became famous as a tool for defrauding creditors before reforms of bankruptcy, fraud and company laws stemmed the misuse. This threat exists for BiH as well.

<sup>26</sup> On the other hand, unions have some legitimate complaints. On April 29, 2004, unions staged a protest in Sarajevo over the Federation’s bankruptcy law, which limits claims of employees to six months minimum salary once the company is declared bankrupt. They are right to protest: the law should not reduce their real salary to minimum salary, but instead should place a cap on reasonable

It seems unlikely that many political and union leaders will champion the proper use of the bankruptcy regime without extensive education programs – not only for them, but for their supporters – so that a critical mass of citizens will accept these inevitable changes.

3. *Capacity.* Twenty-five bankruptcy judges recently underwent a week-end training course on the new bankruptcy law and procedures. It is well understood by the donor community that this is only a beginning, and that these judges are unlikely to be able to handle the full load of commercial bankruptcy cases in a debt-ridden economy, much less the backlog of SOE privatizations. Ongoing training of other judges, plus hands-on, follow-up training of all bankruptcy judges will be required over the next several years to create the capacity to handle the normal bankruptcy load produced by the commercial sector. Current project design includes extensive work only on a pilot basis, without a clear means of comprehensive roll-out.

A significant problem for judges is not in their understanding of the law, but understanding the economic impact of their work. Legal training does not address the importance of efficient decision-making and enforcement on risk management.

Capacity issues do not stop with judges. Appraisers and enforcement agents are being trained in the new laws, but not in the practical aspects of their jobs. Appraisal has been described as meaningless, based on total misconception of asset value (such as replacement cost) and inadequate understanding of market economics. Although they are court-certified “experts”, they are generally incompetent and have a negative impact on the proceedings. Substantial training and re-education is needed to fill this significant gap.

Trustees, theoretically, have significant powers of enforcement. In practice, they do not yet have the capacity to make the law work. Those being trained in the new system will need ongoing assistance as will other agents on whom they depend. Enforcement officials and auctioneers must be able to support the work of the trustees as well. They too need practical training and assistance.

4. *Alternative Dispute Resolution.* ADR is not currently effective in bankruptcy for two reasons. First, it is not well known yet as an option for settling bankruptcy claims. More importantly, it does not work because the bankruptcy system itself does not work. In more advanced jurisdictions, numerous claims are dealt with through out-of-court settlements because parties know that someone else (the trustee and court) can decide the issues for them if they do not agree among themselves. In that situation, ADR provides the parties with some additional controls and incentives that support non-judicial solutions. In BiH, ADR will only become important when courts begin to consistently enforce judgments and decisions of the bankruptcy trustees.

5. *Legal framework.* Although the general framework laws are in place, there are additional needs.

- a. Procedures. The first need is not substantive, but procedural. Bankruptcy should be covered by a code that completely defines the bankruptcy regime, with other laws subject to the provisions of bankruptcy law. For example, the recent draft leasing law attempted to define bankruptcy issues, which if successful,

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claims. The law should be amended to allow for full salary for a reasonable period based on negotiation with the unions. Creditors need to quantify the risk in order to manage it: they do not need to put employees at higher risk. Indeed, the current law will make it difficult to keep employees at all once there is trouble in a business.

would undermine the system instead of being coordinated with the system. There are also problems with existing procedures in the current bankruptcy law. For example, creditors are required to prepay costs in a way that raises the risk and cost to creditors, while eliminating small creditors from commencing proceedings.

b. Gaps in the law. Several gaps still exist in the new or amended laws. For example, it is still possible for “hidden” debtors to show up late in the bankruptcy procedure, when all claims should have been identified. This is inconsistent with new changes in the system and will need to be eliminated in practice. Moreover, according to a consensus among Roundtable participants, changes to the law on execution are insufficient for the needs of the reformed system: the new law is an improvement, but a mediocre one.

c. Debt classification. Proper determination of priorities is hampered by poor debt classification. For SOEs, amounts owed by the state and its various agencies represent the largest debts and these tend to be treated equally with other forms of debt. At times there is no differentiation between the types of debt owed to the state – whether “loans” made for political reasons or overdue taxes and social contributions. In addition, there are “virtual” claims from employees who have not worked for months or years, but have maintained their employment technically in order to hold on to benefits. Much of this debt should simply be annulled. Debts need to be better classified within a modern priority framework.

d. Property rights. Poor definition of real property rights makes it difficult to determine the extent of a claimant’s rights based on interest in property, especially real property. Problems of an outdated land registry and cadastre, together with uncertainty over privatization of land leave competing claims unresolved. The new law should permit bankruptcy judges to determine ownership claims judicially, but judges are not yet comfortable within that role.

e. Privatization. With respect to privatization, additional problems arise in the law because the government can halt bankruptcy proceedings against SOEs. This has tremendous negative impact on the possibility of reorganization.

f. Personal bankruptcy. At present, bankruptcy is only available to entities, not to individuals. Many individuals move into the SME regime only after they have tested their abilities as unincorporated sole proprietors. Often, they will use consumer credit to meet needs previously covered through income, and then invest income and other assets into their business, effectively using consumer credit to finance investment. Recent increases in consumer credit have raised concerns about future defaults. Personal bankruptcy options are needed before such defaults begin as a safeguard against economic downturns and to encourage appropriate risk-taking by providing a way out of debt through personal insolvency mechanisms.

g. Credit information. Credit information provides market discipline by rewarding or punishing credit behavior through transparency in debtor payment history. Recently, a private sector credit agency has opened operations in BiH. There is not, however, any law protecting such bureaus in their operations or protecting consumers from inappropriate practices. A law is needed.

h. Gaps in the broader accountability regimes. Since the Roundtable,<sup>27</sup> a foreign investor has identified an additional gap. Bankruptcy is being seen as a tool for defrauding creditors. Experience in Russia, where this problem was first highlighted in development circles, illustrates the issue well. In early Russian privatization programs, it was not uncommon to see a private company purchase public assets or company through a combination of debt and equity. Rather than pay off the debt, however, the board would carve off the real assets, either directly to themselves or to shell companies, then declare bankruptcy for the now valueless company. Legal protections against fraudulent transfers, conflicts of interest, insider deals, and other fraud and corporate governance issues had not been passed into law, so the thieves got away with it. In other words, bankruptcy is only one side of a much more complex corporate accountability issue. In a properly functioning system, debt forgiveness is for those who have acted ethically and responsibly: the rest go to jail or continue to pay. For BiH, there is currently a belief that the Russian syndrome could be repeated here and that some debtors are looking into donor-funded bankruptcy education to learn how they can cheat the system. If there is no gap in the laws, then there is a gap in public understanding.

## Recommendations

As noted, the greater portion of the legal framework is in place (with exceptions noted), so that the Roundtable participants placed other issues at a higher level of priority in the short-term. There was strong agreement on the “soft” issue of public education – that poor understanding of bankruptcy is negatively affecting reform efforts – and also on the lack of capacity to handle current and future cases. At a higher level, it was also noted that bankruptcy reform has a very significant impact on access to capital, secured transactions, and the health of the economy, so that bankruptcy reforms per se were considered to need urgent attention.

1. Increasing Capacity. Judges and trustees are being trained at a reasonable rate given local absorption capacity. Most of the capacity development will come through practice in handling actual bankruptcy cases, which is also being addressed, at least in part, by assisting professionals with actual cases. Current training must be institutionalized to meet long-term need. This will require:

a. *Curriculum Development.* The Law School curriculum must be completely updated and expanded to ensure that future lawyers graduate with the necessary basic understanding of bankruptcy regimes. In addition, professional associations and training institutes need practical handbooks and training materials for continuing legal education (CLE) in this field. To the extent CLE is not being developed under current projects, additional assistance should be provided to ensure that bankruptcy reforms are accompanied by a complete set of curriculum and training materials, and that trainers are trained to continue providing services.

b. *Institutional Development.* Materials will serve little purpose without ongoing, self-sustaining institutions to provide the training. Sustainability

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<sup>27</sup> Issues in this paragraph and allegations regarding possibilities of deliberate fraud by debtors were provided by a long-term foreign investor who asserts personal knowledge of debtors seeking information on how to attend courses so that they could learn the loopholes in the law and defraud creditors.

depends on matching supply and demand for such services. Experience elsewhere shows that mandatory training and CLE requirements are necessary to ensure demand for training services.<sup>28</sup> This demand ensures a base of *paying* clients so that institutions can afford to develop and offer the needed courses. Courses can also be provided by state-funded institutions, such as law schools or judicial training institutes. Private service providers, however, create competition for clients and improve the level of education being offered, as state-funded institutions do not always have the incentives for adapting their courses to the needs of the students.

Ideally, the market should select the service providers. At this point, however, assistance is needed to create or assist a set of organizations capable of offering the needed education. Depending on the area of training, there are a number of institutions theoretically suited to the needs of those involved, for example:

- Laws
  - o Law schools
  - o Judicial training institutes
  - o Bar associations
  - o Other professional associations (trustees, notaries, clerks)
- Practice
  - o In-house court programs (e.g., a training unit in the new commercial divisions)
  - o Banking associations (e.g., for evaluation of property)
  - o Accounting firms or associations (e.g., for financial accounting)
  - o Private training institutes
  - o Professional associations
  - o Business schools

c. *Subject Development.* Implementers note that there is very poor understanding of basic finance and market economics among judges, lawyers (and law professors), trustees, evaluators, auctioneers and others involved with the bankruptcy process. As a result, these individuals delay proceedings or make poor decisions that negatively affect resolution of bankruptcy claims. For example, much of the valuation offered in existing cases is based on purchase price or replacement cost of equipment, with no attention to depreciation or the productive capacity of the equipment, which sensible creditors protest and sensible purchasers ignore. In addition, few understand that even these valuations are irrelevant if there is no actual market – or a very limited one – for the assets to be sold. Extensive curriculum development and training is needed to address these topics.

d. *Commercial vs. Privatization Capacity.* It is questionable whether current capacity is sufficient for to handle commercial bankruptcy cases involving settlement of private-sector commercial debts. It is unquestionable that that the courts cannot adequately handle *both* commercial bankruptcy and privatization

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<sup>28</sup> For example, most states in the US require lawyers to attend a certain number of CLE courses every two years in order to maintain their licenses. Lawyers prefer this mandatory system to a voluntary one: they do not have time to take such courses unless they are forced to. Likewise, many professional associations require education for initial certification and ongoing licensing.

bankruptcy cases. The system can be used to settle issues of state-owned enterprises, but was not designed for that purpose. Experience elsewhere suggests that highly politicized privatization cases can overwhelm a court. In Serbia, for example, bankruptcy judges regularly delay privatization cases involving termination of large numbers of workers due to reasonable fears that their personal welfare may be at stake. As a result, the system bogs down.

The donor community should consider the creation of a separate track for handling state-owned enterprises. This could be by assigning several judges from one court to work exclusively on such cases, or creating a separate court with separate facilities. This has not yet been tried elsewhere in the region, but the results speak for themselves – the bankruptcy regimes are not working well in any former Yugoslav republic, with the possible exception of Slovenia. Once the cycle of privatizations is completed or substantially reduced, resources from the specialized units could then be reallocated into commercial bankruptcy practice.

2. Public Education. Popular understanding of bankruptcy is almost universally poor. It is seen as a moral failure, a form of theft, a sin or weakness of character that unfairly allows the guilty to go unpunished. While bankruptcy can be misused in this way – especially in underdeveloped legal systems – these attitudes overshadow the positive use of bankruptcy for settling claims, releasing productive assets, restructuring businesses into viable activity, and forgiving debts on a reasonable basis. Consequently, it is difficult to garner support for bankruptcy reforms or to get SMEs to turn to bankruptcy courts for help before they become insolvent.

Public education is needed at several levels to address this. First, a national, popular campaign is needed to change basic popular understanding. Second, targeted education is needed for government officials, union leaders, consumer organizations and others to address their reasonable fears regarding misuse of bankruptcy and misconceptions of “inappropriate” debt forgiveness. This is essential as well for reforming the overall regime to ensure that inappropriate behavior is in fact properly sanctioned. New materials should also be introduced in appropriate business education courses.

3. Harmonization of Bankruptcy and Corporate Governance. Public perceptions of bankruptcy as a tool of criminals is based on reality in other transition countries. An analysis is needed to see whether legal changes are being properly sequenced to ensure that bankruptcy reforms do not permit defrauding of creditors (including employees) without sanctions. If proper fraud and governance laws are not in place, then immediate action is needed to reform the existing related laws before privatization increases. If they are in place, then public education can serve to dispel misconceptions and deter fraud by carefully explaining the system of sanctions and consequences.

4. Local Capacity to Identify and Lead Reforms. BiH currently lacks an institution that monitors needs in the bankruptcy regime. In a more developed civil society, there would normally be several organizations – such as bar associations, banking associations and trustee associations – that would actively monitor law and practice, then propose changes or develop educational materials to address needs. In fact, all of

the legal gaps noted above would normally be identified and addressed by such organizations.

Whenever possible, existing reform programs should work *through* and with local institutions in order to build their capacity to identify and address these needs. This is not a matter of asking for comments on a draft law, but working through the law line by line to explain and answer questions, as well as training several individuals in the drafting process. Many Roundtable participants expressed concerns that local capacity is not being sufficiently developed by the donor community. This can be corrected.

It is not clear that any new institutions need to be built, only that existing ones need to be strengthened and charged with the task of leading reforms. Indeed, the needed reforms already identified should be given to appropriate organizations to promote the solution to government, with technical assistance as needed.



## D. Secured Transaction Environment

Secured financing substantially reduces the risks involved in advancing credit. In *The Mystery of Capital*, Hernando de Soto describes assets that cannot be used as collateral for a loan as “dead capital,” costing SMEs worldwide billions of dollars in investment capacity. Resurrecting such capital requires an adequate legal infrastructure for defining property rights, a system for registering such property rights, efficient mechanisms for resolving disputes over those rights, and efficient mechanisms for enforcing the rights. Once these elements are established, it is possible for lenders to use the assets as an alternative way of recovering obligations in the event of debtor default. Secured financing thus increases the availability and improves the terms of credit for SMEs. Clear ownership rights also increase the level of investment in property, leading to more permanent, long-term investment.

An adequate legal infrastructure must include both movable and immovable property within the secured financing regime. Modern laws also recognize that interests can be granted in any form of movable property with commercial value, whether tangible or intangible, permanent or transitory. Moreover, the laws recognize and facilitate a full range of traditional and modern financing devices, such as pledge, fiduciary transfer, financial leases, and chattel mortgages. For immovable property, mortgages are not enough. The law should permit secured interests in leaseholds, rights of use, usufruct, easements, and financial leases, as well as securitization of payments associated with leases, mortgages and interests. Finally, the system must have integrated priority rules to regulate competing claimants to the same property, including secured lenders, lessors, judgment creditors, bankruptcy trustees, employees and buyers of collateral (such as inventory).

Modern systems regulate priorities through registration of rights. Registration protects creditors from “hidden” claims and facilitates meaningful risk assessment and management. For land, registration also provides up-to-date definitions of the nature and extent of interests in any given parcel of land or building. This includes clearly defined ownership information as well as any interests held by others.

A well-designed system significantly reduces the need for judicial involvement in determining priorities or enforcing secured interests. This generally requires initial judicial involvement by which courts provide consistent decisions defining rights in accordance with law. The fact-finding system must be efficient, effective, and rapid in applying priority rules. Once the courts have upheld the system in practice, they can settle disputes more rapidly and without judicial intervention.

As with bankruptcy law, secured financing rests on a foundation of predictable, efficient enforcement. Creditors value collateral based on their ability to liquidate it

### **The Legal Framework for Secured Transactions: A Sampler**

#### *Laws Defining Rights:*

- Leasing
- Mortgage
- Obligations
- Pledge
- Property

#### *Laws Establishing Rights*

- Pledge Registry
- Real Property Registry
- Mortgage Registry
- Vehicle Registry
- Notaries

#### *Laws Affecting*

#### *Enforcement of Rights*

- Bankruptcy
- Code of Civil Procedure
- Consumer Protection
- Execution
- Obligations (self-help)
- Notaries
- Tax

#### *Additional Regulations*

- Appraisal
- Auction Procedures
- Court Book of Rules

rapidly at market value. In the most effective systems, creditors are permitted to dispose of the collateral themselves, subject to appropriate requirements regarding notice and sale conditions, without having to use the courts. In some instances, however, official involvement is needed to seize movable property or evict tenants without undue use of force. When assets are liquidated, their value should be determined by the market during transparent, public sale procedures.

## Current Situation in BiH

At present, the legal framework for a modern, secured financing system based on registered notice does not yet exist. However, it is underway. Donors have made substantial progress in revising the legal framework to address the inadequacies in existing legislation. Ongoing activities by USAID, SEED, and GTZ produced drafts of the pledge law, leasing law, law on obligations, property law, notaries law and bankruptcy law. USAID designed a nationwide movable property registry, which will take effect when the government passes the relevant laws. Land books and registries are currently non-transparent, inaccurate, incomplete, and difficult to access, with registrations beset by unnecessary judicial interventions; GTZ and SIDA, however, have plans to address most of these issues under their joint project pending additional funding.

The situation for dispute resolutions and enforcement is in flux. Currently, no efficient mechanisms exist either inside or outside of court. As noted in the section on Bankruptcy, numerous donors and implementers are working on various aspects of these problems. For example, USAID is addressing improved court and case administration, while World Bank, SEED and USAID are introducing mediation to the business community as an alternative to litigation. USAID and IJC's work on enforcement work includes legal training of execution officers and appraisers, as well as education of judges. The impact of these efforts is limited for a number of reasons: it is too early in the process, the responsible institutions are not effectively staffed, and traditional biases against creditors (including poor understanding of the time value of money) continue to haunt the decision-making and enforcement process.

GTZ has also introduced a new draft law on notaries that would shift some enforcement and registration responsibilities from the parties (including their lawyers) to notaries. The approach follows German concepts that combine consumer protection with regulation of certain types of transactions by creating a "monopoly" of sorts within the notary system while also holding notaries responsible for their performance. There is controversy within the donor community regarding this approach, with some donors suggesting that other European notary models or common law models would serve the economy more effectively. All agree on the goals; disagreement regards methodology.

## Gaps

Roundtable participants recognized a number of gaps in current and planned interventions. These were prioritized on the basis of impact, as delineated below. The legal framework was identified as the most important, because secured transactions are completely dependent on having the laws in place. Once in place, however, enforcement is essential to ensure existence of the rights set forth in the laws. With this basic structure in place, it is possible to "unlock" the substantial capital inherent in real property, but this requires adequate and accurate registration of

real property ownership rights. All of these in turn require substantial education and training to ensure implementation.

*Legal Framework.* Roundtable participants agreed that the highest priority was harmonization and passage of the various laws constituting the legal framework. Currently, most of the laws are still drafts awaiting adoption, which is a pre-requisite for establishing the secured transaction regime. Assuming passage of the proposed draft laws, there will be no significant *gaps* in the overall legal framework, but there may be overlaps and conflicts.

However, implementers also agree that in the short term **the quality of the framework depends on donor coordination**, so that coordination is an even greater priority than passage, to ensure adoption of a functional, harmonized system. Normally, such coordination is carried out by subject and drafting specialists in the ministries and legislature, but this expertise is insufficient in BiH. Consequently, donors need to coordinate their strategic and technical approaches. Currently, overlapping provisions and redundancies, if not changed, will reduce the availability of secured financing devices. For example, the draft leasing law invalidates unregistered leases, which would otherwise be valid under the law on obligations, subject only to a loss of priority under the law on pledges. Likewise, bankruptcy provisions will permit unjust enrichment of lessors under the draft leasing law, unless the law properly characterizes residual values under financial leases.

For the short-term, this is a donor coordination problem; for the long term, **BiH needs a lawmaking process** that can address these kinds of issues. As with any legal system, circumstances dictate the necessity for new laws, ongoing amendments and minor adjustments. At present, there is little local capacity for ongoing, organized, systematic, legislative reform. Donor-driven reforms have not yet resulted in sufficient capacity development at the institutional level. Moreover, **private stakeholders are generally unprepared to provide meaningful input** into the process even if given the opportunity. This cycle of feedback is instrumental in supporting modern, democratic lawmaking systems.

Donors have now recognized the need for more deliberate coordination in this area and are creating multi-donor working groups to ensure more efficient and effective use of resources. Roundtable participants also raised the concern that **best practices**, which have been proven elsewhere, are not properly being reviewed or adopted in BiH, and that there is insufficient analysis of costs and benefits of different legal options. (This concern focused in part on different approaches to the role of notaries in the future BiH legal systems.) The new secured transactions donor working group is much needed, but still does not address the issue of local capacity to coordinate, direct, and decide how laws should be harmonized and selected.

Roundtable participants also identified an additional specific gap in the current regime: lack of harmonization between administrative procedures and expectations regarding registration of leased vehicles. Currently, only the owner of an automobile may register the vehicle and obtain a license. Someone who leases a car may not, therefore, register the car in their name. Some leasing companies believe that lessees should be allowed to register the leased vehicle and thus take direct responsibility for all licensing requirements. This problem can also be addressed by leasing companies

handling all registration and passing the cost to their customers. However, the issue should be expressly addressed and decided; if changes are made to the law, administrative regulations will need to be re-written and disseminated to all stakeholders.

*Enforcement and Execution.* Rights are theoretical unless enforced. Court enforcement is not the first resort for lenders, or even the second: it is the last resort. When used, however, it is the only resort. Enforcement institutions are far from effective today. The gaps in effectiveness are at two levels. First, there is widespread agreement that recent amendments to the law on execution were helpful but insufficient. As the law is applied, new gaps are surfacing. In addition, the amendments simply did not adequately address the needs in the enforcement regime. This gap suggests a fundamental lack of understanding that time is of the essence for businesses and economic activity, or that valuation and sale should be more closely linked to market economics. A coordinated overhaul of the entire law is needed, especially in light of the recent radical changes in the code of civil procedure.<sup>29</sup>

Second, there is a gap in planned training and resources for judges and execution officers. Current efforts focus on providing a basic legal understanding of the secured transaction framework. Such knowledge is necessary, but far from sufficient. Long-term training plans should include hands-on, practical training and mentorship of execution officers, and concentrated work with judges to ensure consistent judicial findings based on law and not misconceptions based on historical bias towards debtors. It is also not clear that execution offices have sufficient staff and resources to perform their duties adequately. Training and public education will also be needed for stakeholders involved in self-help provisions of the draft pledge law. For situations where self-help is not available, it is imperative that the lengthy process of seizing and selling secured property be improved dramatically, or else lenders will continue to be reluctant to engage in secured financing.

*Registration of land ownership and updating the cadastre.* Clear ownership rights are the basis for using property as collateral for loans. SMEs complain that lack of sites for construction are a major constraint to development. This deficiency is not an issue of too little land, but too little land with established, transferable ownership rights that are secure enough to justify investment. Current projects will improve data accuracy and transparent access to information, but the process of registering ownership and updating the cadastre at planned rates is likely to take ten years once the systems are in place at the end of 2004. Current resources are insufficient to meet the needs of increased demand for these activities. Current commitments for assistance extend only through 2005. This gap has serious consequences for economic growth and development in light of the importance of mortgage finance to SME development.

During the Roundtable, several participants noted that the ten-year timeframe could conceivably be reduced depending on approaches, suggesting that there could be a gap in viable solutions being offered. It was also significant that several participants did not know that the approach being implemented by GTZ and SIDA combines both systematic updating of records with “as-needed” updating, so that individual parcels

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<sup>29</sup> The recent changes in civil procedure were more than amendments: the dysfunctional Yugoslav system has been replaced with a new model. This reform requires numerous other reforms in related legislation, including the execution law and the book of rules for courts.

can be cleared and updated if owners need their rights clarified before the scheduled systematic clarification.

Participants noted that there is a further gap in the process of establishing clear ownership rights and information because of land transfer taxes. BiH charges a 6% fee on the value of land transferred, which is four to six times higher than developed country standards of 1% to 1.5%. The impact of this is that sellers do informal transfers to avoid the tax, or, if the parties opt to register the sale, they dramatically understate the value to reduce the tax payments. By overtaxing land sales, the government entities involved are retarding rationalization of the land markets.

*Training and Education.* In addition to training issues raised above, there was clear consensus that extensive reforms are needed in the education and training framework to ensure adoption and sustainability of the new secured transactions regime. Each reform needs to be woven into the curriculum of the law school as soon as possible; there is no mandatory continuing legal education for lawyers or notaries, so there is no guarantee that lawyers will receive any additional education once they leave school. Likewise, all reforms need to be accompanied by practical training materials that can be taught through local institutions such as judicial training institutes, clerks and lawyers associations, and others. In most cases, however, there is little if any institutional capacity to offer such education on a self-sustaining basis because of institutional weaknesses.

## Recommendations

1. Donor Coordination. Donor coordination is needed to ensure the quality and consistency of the needed reforms in the legal framework in the short-term. This coordination is needed at two levels: policy and strategy. Policy coordination focuses on what needs to be done; for example, a determination that the secured transaction legal reforms should include coordinated reforms of enforcement, leasing, obligation and bankruptcy laws. Strategic coordination concerns who does what and how they do it. For example, strategic considerations might result from a donor working group deciding to have a GTZ project provide input on a USAID training program to ensure coverage of changes in the Obligations Law and to avoid “donor fatigue” for stakeholders from overlapping and redundant training programs.

Since the Roundtable, donors and implementers in this area have already organized a coordination and working group to address a number of the inconsistencies highlighted during the Roundtable discussions. This group may benefit from a clear definition of mandate, roles and responsibilities, with one implementer or donor responsible for ensuring any necessary ongoing collaboration.

In the event of conflicts, implementers look to their funding agencies for direction. Donors need a rational mechanism for determining whose strategy should “win”, preferably based on cost/benefit analysis and best practices from comparable situations, not simply funding and longevity.

2. Enforcement Law and Practice. There is need for focused technical assistance to provide comprehensive evaluation of the existing law and practice regime. Local and foreign experts have indicated that the goal is not simply to amend the system, but to overhaul it. A new system is needed to provide for efficient, effective, and reasonably low cost seizure and sale of movable and immovable property to support secured financing. Once process and legal changes are identified, the program will need to

provide extensive, practical on-the-job training to those working in the field of enforcement through associations and other permanent institutions that can continue to offer and revise their training for new entrants and changed circumstances.

3. Land Registration. Current plans envisage roll out of the cadastre and registration systems by the end of 2004. Once software and equipment are installed, it may take up to ten years to update ownership records. Unless additional funding or new approaches are developed to speed up the process, it is important to prioritize initial interventions in terms of both economic growth and ethnic harmony.

Improved ownership records are only one part of the equation. Taxation of land transfers, mortgages, and other land-related transactions is having a very strong negative impact on secured lending and even registration. Transfer taxes should be reduced from 6% to a more reasonable level (preferably no more than 1%), but this reform must take place within a more comprehensive tax reform program to avoid simply moving the excess burdens to some other market-distorting location.

4. Education and Training. Separate, complementary training and public education programs are needed for numerous stakeholders. Programs are needed in:

- Why and how to register pledges on movable property for
  - o Banks, finance institutions, leasing companies
  - o Legal professionals (lawyers, notaries, in-house counsel)
  - o Judges
  - o Business associations and consumer advocacy groups
  - o Policy makers (government officials, to ensure support)
- Practical issues of enforcement for
  - o Enforcement officers
  - o Appraisers
  - o Court clerks
  - o Legal professionals

Professional education needs to be updated dramatically. Today's law schools are educating tomorrow's lawyers, judges and notaries based on yesterday's needs. As new laws are passed, law schools need to introduce changes in their curriculum to incorporate the changes in both laws and legal theories underpinning the new laws. Local resources are insufficient to meet the needs, suggesting that either existing projects should work with local law professors and others to develop new materials, or that a separate project take on this task. Either way, the need is urgent.

Continuing legal education (CLE) courses should also be developed for existing legal professionals. However, it should be noted that the supply of CLE does not necessarily correlate with demand for such courses in transition countries. Experience elsewhere shows that lawyers (and other legal professionals) will take additional courses when they are (1) required to, or (2) can be sued for malpractice if they have not upgraded their standards. Serious consideration should be given to establishing

mandatory CLE requirements for lawyers so that there will be sufficient ongoing demand to support the development of a CLE industry.<sup>30</sup>

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<sup>30</sup> Experience elsewhere in the region suggests many lawyers actually support such mandatory requirements, in part because it is difficult to allocate time away from billable client matters unless it is required.

## E. Taxation<sup>31</sup>

From an SME perspective, taxes are a cost. They may be justified, they may be used beneficially by the government for the enterprise – or they may not – but they constitute business costs that must be passed on to the customer through increased prices or absorbed through the reduction of other costs. In cross-border or international markets, it is often impossible to raise prices and stay competitive, so that taxes must be absorbed. A seller that cannot absorb tax costs to compete in this larger market will fail. As a result, the SME environment needs affordable taxes based on a tax system that is economically efficient, with rational and fair tax policies, low costs of tax administration and compliance, and high rates of compliance among taxpayers.

Governments rely on taxes to exist and provide services. If the government is larger than the tax base can afford, the rate of taxes will be increasingly difficult for the market to bear, impeding growth of income and rates of development. At the same time, tax evasion will increase as a survival strategy, leading to distorted competition between those who comply and those who do not. In some instances, excessive taxes will lead to a growth in the gray economy, further eroding the tax base and leaving the smaller formal economy to carry the entire load imposed by the government. For SMEs to grow, they must be able to absorb this tax burden.

All taxes affect business growth and competitiveness, whether directly as an added cost or indirectly through their impact on the economic health of the market. Consequently, for governments to stimulate growth and improve national competitiveness, it is desirable to keep overall tax rates low. To do this, governments must face the same challenge as businesses: they must also balance costs, risks and revenues to increase their tax “profitability.”

Tax policymakers often rely simply on rate increases for tax revenue needs. This is a poor starting point. The first focus should be on reducing unnecessary costs in order to better understand the true reasonable cost of government for basic services (including the cost of collecting taxes) and set the tax rate to meet those needs. If the market can bear higher costs for more services, then rates can rise accordingly; if not, increases in tax rates will lead to increases in risks.

For government, risk is directly associated with the risk imposed on business. As taxes increase, businesses begin to balance the legal risk of non-compliance (penalties for getting caught) with the market risk of higher costs. At a certain point, they will begin to favor tax evasion, which will undermine the government’s revenue program. Government then faces a higher risk of non-compliance, which is directly affected by its ability to enforce the laws. Where taxes are too high and enforcement is too low, evasion will be rampant. Improving enforcement will improve revenue collection, but if the tax rate is still too high, then government will be seen as oppressive and

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<sup>31</sup> This section is adapted from *Toward an SME-Friendly Revenue System in Bosnia and Herzegovina*, February 2004, prepared for USAID’s Tax Administration Modernization Project by Mark Gallagher. The study was presented at the Roundtable, but not expressly addressed in break out groups. Numerous participant comments on tax issues, however, are included in this summary.



businesses will close down or leave for better markets, leading to stunted economic development.

Revenues are not simply a matter of tax rates, but of tax rates applied to the largest possible pool of taxpayers. Taxes should be set equitably, without inappropriate exceptions for some taxpayers at the expense of others, or else the market will become distorted through unfair competition based on tax inequitable tax burdens. New governments often suffer from a certain naiveté regarding who bears the burden of business taxes: ultimately, they are borne by the consumer through higher prices or lower services. Excessive taxes can lead to business failure, especially among SMEs, which also has an impact on consumers and employment. Although business-related taxes are an efficient way to spread the tax burden, policymakers should recognize who bears the final cost.

## Current Situation in BiH

The focus of this analysis is to recommend changes in the revenue systems in the two Entities of Bosnia and Herzegovina (BiH) and the District of Brčko with the intention of reducing impediments to private-sector business development, especially that of small and medium enterprises (SME).

Last year, revenue performance throughout BiH was positive. In the Federation, total revenues, excluding customs and excises, increased by 12%. In the RS, revenues, again, excluding customs and excises, increased by 14%. On a gross basis, i.e., including customs and excises, revenue growth was only seven percent in the Federation and 10% in the RS. Brčko enjoyed a 28% increase in revenues, despite a 20% decline in its customs revenues.

With the opening of the Bosnian economy to Europe and greater trade partnering with its neighbors, the role of import duties as a revenue source is on a decline and domestic taxation must be developed for alternative government funding. Customs duties declined three percent last year in the Federation, two percent in the RS, and 20% in Brčko.

Last year's overall revenue increases with declining returns from customs do not indicate an efficient system of rational tax imposition and collection. These increased revenues do not reflect an efficient tax system based on reasonable rates. A close study reveals disturbing findings. For instance, uncoordinated and poorly designed tax policies impose, in nominal terms, very heavy burdens on labor and business and distort economic decision making. The institutional set up in the country has led to a plethora of tax rates and tax bases, causing confusion and uncertainty among businesspersons who cannot be sure what their requirements are, and belies the notion of creating a "single economic space."

Several donor projects are addressing some of these tax issues, some of which must be seen as legacies from the Yugoslav past and outdated attitudes toward taxpayers and taxpayer control. The EU's Customs and Fiscal Assistance Office and USAID's Tax Administration Modernization Project (TAMP), have been able to make significant inroads in their fields of intervention. The EU project has already brought significant improvements in customs administrations and rate reductions. TAMP, when fully implemented, will reduce a great number of administrative hurdles in the

tax system. However, this assistance is devoted to automation and database development of most aspects of tax administration; it does not address the significant problems found in audit and enforcement. The progress in tax administration modernization that has been achieved already, and it is appreciable, provides a solid basis for initiating a complete rationalization of the tax system.

USAID's recent analysis of the Bosnian tax system has extensively analyzed the situation from the municipal up to the Entity level, but is still not quite complete.<sup>32</sup> Some taxes or other revenue sources were not included in the analysis. The issues related to sales tax, excises and customs duties, and VAT and the establishment of the Indirect Tax Administration (ITA) are not addressed. In addition, the nature of the various entitlement funds (pensions, health, child protection, and unemployment) is not included in the analysis, even though they comprise a major share of government revenues.

The sales tax, a major revenue source throughout BiH, is about to be replaced by a state-wide Value Added Tax (VAT). This VAT, all excises, and all international trade taxes will be the domain of a new state-level Indirect Tax Administration (ITA), and therefore not treated in this analysis. More study of this topic is needed. With the creation of the ITA, the introduction of the VAT, and the reductions in import duties, the need for overall tax reform is even more urgent. The assimilation of these changes into a healthy and SME-friendly public revenue system urgently depends upon the development of new means for distributing fiscal revenues among the levels of government, although this issue has not been covered in this analysis. Tax issues are a serious impediment to SME growth and development in BiH. According to the World Bank ARCS survey:

In both the RS and the FBiH, most of the subjects are of the opinion that the tax rates, tax regulations/administration and unfair competition of the gray/shadow economy (monopolistic practices) do present obstacles for the functioning and growth of their businesses. The assessment in both the RS and the FBiH is that these are very serious obstacles.<sup>33</sup>

Impediments identified by business are daunting. They include:

1. Accounting. Accounting rules for taxation are unclear, difficult for small businesses to manage, and impede establishing business in a variety of municipalities. This includes the problem that tax inspectors do not seem to be very familiar with tax law or accountancy and they often apply the law in different ways on different occasions.
2. Inspections. Tax inspectors show up unannounced and too frequently, requiring tremendous allocations of time and money at the expense of business operations.

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<sup>32</sup> World Bank has addressed several related issues in its June, 2003 report *BiH, Creating an Efficient Decentralized Fiscal System*, but there is still need for additional analysis.

<sup>33</sup> World Bank, *Analytical Report on Administrative and Regulatory Costs Survey for Bosnia and Herzegovina*. April 2002.

3. Inefficiencies. There is a wide variety of taxes imposed by the three levels of government and the entitlement funds. Tax payments must be made in multiple payments.
4. Wage taxes. The nominal wage taxes, including social fund payments, are very high, reaching 69% of salaries in the FBiH, 52% in the RS, and up to 46% in Brcko. Businesses generally under-declare the wages they pay to reduce this burden, often with the knowledge of tax authorities.
5. Skewed incentives. Tax holidays for “new” businesses encourage businesspersons to open and close their businesses to take advantage of these tax holidays. This then leaves them without a formal business history against which they can borrow from the formal banking system.

It is interesting to note that in most of the conversations with business people, the issues of taxation did not arise as impediments to business operations until prodded. Nonetheless, once prodded the issues of multiple payments, differences of taxation among localities, and the exorbitant taxes on wages, were all emphasized. All but one of the businesspersons interviewed freely admitted to under-declaring their wage bill. The one businessperson who claimed to make all the legally required tax payments is no longer in business.

## Gaps

*Outdated tax systems.* Most of the country’s taxes date back prior to the collapse of Yugoslavia, are incoherent, non-synchronized, create serious economic distortions, are inequitable, impossible to enforce, and if enforced would essentially eliminate any possibility for private sector economic development. The system imposes a number of so-called citizen taxes multiple times on the same base, treats different sources of income differently, and is poorly enforced. The “sign-tax” is actually an additional business-licensing fee having nothing to do with signs, and which should be eliminated through rationalization of business licensing.

Other taxes defeat the purposes for which they were designed. Profit taxes include so many loopholes and tax holidays that they result in almost no revenue collection. The taxes on wages, when coupled with contributions to the various funds (when actually paid), cannot be borne by business and discourage formal sector employment. Nominally, the tax system discriminates heavily in favor of capital and against labor. Considering that Bosnia is a labor-surplus country, as evinced by high unemployment, this policy is in direct conflict with economic reasoning.

The real estate tax is imposed throughout the country, but it is very poorly designed. It is a tax on area rather than value and it does not include land. Municipalities have been stealthily applying their own versions of the property tax under the guise of fees or charges for services. At the same time, a tax on the sale of property, with the property value as the basis, is also imposed.

*Poor tax administration.* Despite considerable assistance to date, the RS has not yet adopted the tax certification process recommended by TAMP, although it has the information technology (IT) systems in place to greatly streamline this process right now. The Federation has also been slow in the implementation of certain aspects of

its modernization, including the continuation of a cumbersome certification process (which Brčko District has already streamlined). In the Federation, the tax payment process is onerous, especially for small- to medium-sized businesses.<sup>34</sup> Making it difficult to pay taxes encourages tax evasion.

*Incomplete donor assistance.* Donor assistance has focused primarily on improving tax administration, which is quite necessary, but not sufficient. Except for the efforts of GTZ in the area of income tax reform, VAT and the creation of the ITA, there has been little attention paid to tax policy. Bosnian institutions have no existing capacity to analyze and design tax and revenue distribution policies. CAFAO is doing some work with audit, but has not yet developed the IT systems needed for modern audit selection, risk management, or analysis audit and collection data. Support for enforcement is currently outside the scope of any donor assistance, but desperately needed.

*Inefficient institutional structure.* Multiple levels of government, especially in the Federation, have resulted in substantial inefficiencies and redundancies. Cantons set tax policy, municipalities benefit, and TAFBIH administers these taxes and fees. Many of the fees and charges imposed by the various government units are actually taxes that are created without proper legal authority by decree or through rulebook amendments. Due to poor management of the overall system, it has become Hydra-like: eliminate one tax and it reappears in some other form or simply unaltered at a later date.

## Recommendations

The recommendations set forth below will require considerable effort by a large cast of players. Assistance in tax administration modernization must be completed and expanded into specific areas that until now have not received adequate attention, namely systemization of audit, collection and enforcement functions. These efforts must be accompanied by deep policy reform, such as the implementation of the new income tax laws and the elimination of a number of the so-called citizen taxes. Property tax needs to be reformed and it should be implemented solely for and by municipal governments. Legislation needs to be drafted, enacted and implemented to regulate the entire revenues systems of BiH. Policy dialogue must begin immediately and interlocutors must be found and educated. Capacity to carry out policy analysis and policy design and implementation and sector monitoring and control is sorely required

1. Reform tax policy. The overall tax burden on business is retarding growth, development, investment and employment. Tax policy should focus on simplification by immediately implementing the profit and income tax laws, eliminating numerous individual taxes and, where appropriate, incorporating them into the income tax. Taxes that should be eliminated and revised include:

- Specific taxes on income that belong within the basic income tax regime, such as:
  - 30% citizen/property tax on interest earned

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<sup>34</sup> This is not the case in the RS or Brčko. Although TAMP has identified and reported this onerous process, efforts for correction of the process is outside the purview of TAMP and must be taken at Ministry of Finance level.

- Taxes on income earned from patents, innovations, and copyrights
- Separate tax on agricultural incomes
- Wage taxes
- Special taxes on consumption of alcohol and soft drinks, which should be incorporated into normal excise taxes

In addition, the pension and health fund should be closely analyzed within the context of overall tax reform. The World Bank will be undertaking a study of these issues, which should be coordinated with all other tax work.

Property taxes must be reformed, based on property values and including all real estate, including residences (in Federation), as well as land. Ideally, this should be solely a municipal tax with national or entity-level legislation, and administered by municipalities. The tax on the sale of property should be dramatically reduced. Current rates of 6% of value are four to six times higher than international standards of 1% to 1.5%.

The tax on vehicles and boats requires a separate analysis. This can be a solid revenue source for municipal governments allowing reduction or rationalization of other taxes and fees.

2. Improve tax administration. Tax administration throughout the country needs additional reforms. These include:

- Eliminate the multiplicity of tax payments required in the Federation.
- Reduce the frequency of tax payments (NB: this may be obviated with the introduction of VAT).
- Streamline the tax certification process, immediately in the RS, as soon as possible in the Federation.
- Adopt the amended Rulebook on Organizational Structure for the Federation Tax Administration that provides a formal requirement for a central processing center (CPC), establishes appropriate IT positions and enhances requirements for taxpayer service and education.
- Implement the Federation CPC in Mostar, immediately.
- Deepen the concept of customer service in the tax administrations.
- Implement the taxpayer education and service activities immediately and make these constant activities of the tax administrations.
- Build the information system links and reporting and selection systems required for tax audit selection, informed tax audit, tax audit monitoring and performance monitoring.

3. Build institutional capacity. There is no significant local capacity for tax and fiscal policy analysis. To address this, the Ministries of Finance for the RS and the Federation should each establish an Office of Tax and Fiscal Analysis (OTFA) as a supplement to the planned council of finance ministers that will be part of the Indirect Tax Administration (ITA). Donors should then provide substantial support in training and education of OTFA officials in the areas of tax policy and fiscal analysis. Over time, the two OTFAs could conceivably be merged into one national office at the state level, but in the meantime it would be important to ensure coordination and

collaboration to avoid undesired market impact from divergent policies. The OTFAs should be responsible for analyzing all taxes proposed by governments, recommending changes and approving final proposals. In the Federation, no canton should impose taxes without OTFA approval, and these should be collected by the TAFBIH.

4. Legal/institutional reform. The most efficient approach for legal reform is to change the constitution, but this is unlikely in the near term when numerous changes must be made. Consequently, the following laws should be developed and implemented:

a. *Organic Law on Public Revenues in the Federation.* This law would prescribe the types of taxes and fees that cantons should introduce, define how these would be qualified or authorized by the OTFA, and provide authorization for the TAFBIH to collect only taxes approved by the OTFA. This Law would be superior to any other cantonal law. If possible, the law would also define the taxes and revenues that may be charged by municipalities. At a minimum, this law would have to deal with:

- Real estate taxation
- Municipal authorities for real estate tax administration
- Implementation of the profit and income taxes
- Authorization of all tax and fee types and levels
- Coordinate the taxation among levels of government
- Derogations

b. *Organic Law on Public Revenue in the RS.* This law would establish the guidelines for establishing Entity-level taxes and define the fees, charges, and other revenue sources for municipalities. This would be similar to that for the Federation, but would obviously not need to concern itself with cantonal authorities.

Both of these laws should clearly establish how taxes can be created and make clear the difference between a tax and a fee. This applies not only to cantons and municipalities but also to tax and fee creation at the Entity level.

## **F. Trade, Competition and Labor**

The gap analysis prepared for the Roundtable focused on high priority gaps identified by donors and SMEs. While vitally important, these gaps did not cover all of the areas in need of reform. SMEs are significantly affected by a number of other legal regimes. Among the most important, according to studies of businesses conducted by FIAS and the World Bank, are trade, competition, and labor.

### **Trade**

Trade laws affect SMEs in a variety of ways. First, regional and international trade agreements lower the barriers to cross-border markets and effectively increase the overall size of the market being served. For example, the BiH market consists of only a few million potential consumers, but if doors to neighboring markets are opened, investors have access to more than 20 million consumers in the former Yugoslav republics alone. This provides tremendous revenue growth potential, but also requires the establishment and implementation of various certification systems (such as ISO 9000) to ensure competitiveness of local products in the broader markets.

Trade regimes also cover issues such as intellectual property rights (IPR). Protection of IPR through adoption and enforcement of well established international regimes on patents, copyrights, and trademarks provides SMEs with the opportunity to increase revenues both locally and internationally, through sale and export of IPR as well as products created with IPR they develop. Without protection, there is little incentive for research and development in science and industrial design, where high costs can only be recouped through protection of the rights created. Likewise, software and creative works (such as music, art and literature) become devalued if competitors can freely copy and commercialize the works without appropriate payments to the creators.

Many policymakers and SMEs have a poor understanding of these issues, often leading to opposition of a more open trade regime, at least in the short term. SMEs often want the trade laws to increase barriers against imports and foreign competition while also increasing access to their competitors' markets, a combination that does not sell well in trade negotiations. Many feel that intellectual property rights represent unfair restraints on reproduction and sale of various items – whether music CDs or pharmaceuticals. Enforcement of IPR is problematic throughout the transition world.

### **Current Situation in BiH**

BiH recently suspended regional trade agreements for 90 days in an effort to provide protection and advantages to a number of agro-industry producers. While the short-term perspective seemed to justify this breach of obligations by policy-makers, greater impact has been felt at a number of levels.

First, the disavowal of agreements with Croatia and Serbia & Montenegro resulted in temporary suspension of donor project support for WTO accession, placing BiH further behind on its goals for entering WTO and establishing itself more fully in the international trade regime. On a regional level, the longer-term repercussions are not altogether clear, but this policy decision did not help BiH in extending the benefits of regional market access to its exporters and consumers. The EU will provide project

support to get the country back on track through existing commitments for assistance with regional, EU, and international trade agreements. Whether other donors will assist again in WTO accession after the recent abrogation of local agreements remains to be seen.

In the area of intellectual property rights, BiH is known for poor enforcement, based in part on poor understanding of the implications. This is not just a matter of the ubiquitous sellers of pirated music and DVDs, but rather an issue of protecting local producers of intellectual property and enabling SMEs to import state-of-the-art technology and software (or even pharmaceuticals). SMEs are thus at a competitive disadvantage in this area. At present, only the EU has any stated program of assistance, which is aimed at harmonizing IPR legislation, not at enforcement.

The World Bank is assisting with trade issues related to customs administration. The goal of the program is to rationalize the customs regime, improve inspections and inspectorates, and introduce risk management approaches to boarder posts to speed the processing of imports and exports. Tariffs have already been reduced and procedures are being simplified. The impact should be lower costs to both SMEs and consumers, and higher revenues to SMEs as they are better able to export at reasonable costs.

## Gaps

The standard donor approach of getting the overall framework law in place as a starting point does not have to define the approach to trade. WTO accession, while important, does not inhibit the development of immediate, high impact reforms based on international standards (including WTO standards). Consequently, the highest priority gap is in the customs regime, which is being substantially improved now, while WTO gets back on track. Accession takes time and so should be addressed again as soon as possible, but the timeframe required is also an advantage: there is time to address problems of understanding before the trade regime is actually implemented.

*Customs Reform.* The World Bank interventions in customs are practical and much needed. Success will require wide public education among SMEs (so that they know and can insist upon their rights) and extensive practical education among inspectors. Macedonia recently achieved remarkable success in customs administration reform through a combination of strong political will (including prosecution of violations) and donor support. It is not yet clear that the necessary political will is in place. As noted elsewhere in this report, there is also a gap in understanding of the role of government that can undermine the pace and longevity of customs reform. For centuries, the primary purpose of customs inspections was to generate wealth for the inspector and, to a lesser extent, for the state. Inspectors had tremendous discretion, so that the sale of privileges or offering of discounts could not necessarily even be characterized as corruption or abuse of power. To the extent that these expectations still linger in the minds of both inspectors and inspected, it will be difficult to shift paradigms from control to trade facilitation based on rights and obligations. No programs were identified that are undertaking this kind of public education.

*Framework.* Much of the current assistance is aimed at the framework level: getting laws and agreements in place. Experience elsewhere suggests that a great deal of



practical assistance will be needed to ensure implementation of WTO regulations or IPR laws and treaties. Enforcement issues will require special, focused attention on courts and enforcement officers as well as the business community. These issues do not seem to be covered by current projects.

*Trade Regimes.* There is a gap in public understanding of the purpose and impact of trade regimes. Although many SMEs complain that trade issues are affecting their success and profitability, at least some part of this complaint is that the government is not raising protective barriers. This is a normal (indeed, universal) desire of businesses everywhere, which belies an understanding that such barriers raise costs to all consumers for the benefit of a small number of producers. Such subsidies have a negative net economic impact. Policymakers with no significant appreciation of basic market economics will be hard to convince of the need for various necessary reforms, especially if there is only external (foreign) pressure not supported by the local population.

## Recommendations

Lack of understanding affects the social dynamics of reform. Until people know the benefits of reform, they are unlikely to exert pressure for the reforms or to support reforms underway through changed behavior. Improved understanding is particularly important in areas subject to poor understanding, such as the benefits of a more open trade regime.

1. Create a public awareness campaign for customs reforms. Until SMEs understand that they have the right to predictable, transparent application of published tariff rates and inspection limits, they will be hindered in their ability to overcome abuses of discretion. Public knowledge of rights and obligations is an essential pillar of support for customs reforms. The campaign should be developed in collaboration between the Customs Administration and SMEs associations (such as the newly independent chambers of economy) to ensure maximum understanding from both sides of the problems, and a better sense of public-private partnership for reforms. In addition, the campaign should target to lawyers, business consultants, freight forwarders and any others connected with the import/export business. Particular attention should be given to export clusters being supported by donor programs.

2. Create a public awareness campaign on the benefits of more open trade regimes. The lack of public understanding of the benefits of freer trade is not just limited to BiH – it can be seen in the street protests accompanying every World Trade Organization meeting in the world today. For a country such as BiH, there is understandable fear that lower tariff barriers will result in loss of market positions and jobs among local SMEs that cannot compete in imports. There is virtually no understanding that this also means lower costs to consumers and manufacturers as they are able to purchase needed items more cheaply and use their savings for other productive means. There is also little understanding that trade liberalization provides greater access to larger markets at more reasonable terms, which will greatly benefit export-oriented production by SMEs. Recent abrogation of regional trade agreements to protect local producers was quite popular among the general population. Changing this base understanding will require carefully crafted public awareness programs. These will in turn create a better base of support for needed reforms.

3. Re-establish assistance for WTO accession and compliance. It is clear that BiH does not currently have the internal capacity for achieving the pre-requisites for WTO membership and will continue to need donor support. However, this may first require a focus on political will by creating a better understanding of trade regimes among politicians. Renewed assistance should include substantial resources for public education and public awareness of the benefits of freer trade, preferably with specific examples of benefits to be gained.

## **Competition**

SMEs face competition at two levels. First, their success depends on their ability to serve the market as well as their competitors by providing acceptable goods and services at reasonable prices. Fair competition drives down costs to consumers (including SMEs, who need low cost inputs from their suppliers) and improves services. It also results in failed businesses that cannot make necessary adjustments to their rivals' competitive strengths; this is a cost of market-oriented systems found in every healthy economy. On the positive side, however, it helps SMEs lower their costs and increase their efficiency to better compete in global, regional and local markets.

Second, there is unfair competition. For SMEs in transition economies, this comes from two sides. Abuse of dominant position and use of unfair trade practices such as price-fixing allow misuse of power to keep new entrants out of the market or drive out existing competitors. These problems are normally addressed through competition laws, which are supposed to ensure a "level playing field" for all market participants. On the other hand, competition can come from illegal activity such as bribery of customs officials or informal businesses that reduce costs through tax and compliance evasion, thus enabling them to substantially undercut the price of formal sector competitors. Addressing these requires different approaches.

Unfair competition undermines the abilities of SMEs to enter or maintain markets by cutting their revenues while sometimes raising costs. If risk of unfair competition is high, formal SMEs are unlikely to undertake the expense of developing a market at all. This has a negative impact on tax revenues, consumer protection and economic growth.

## **Current Situation in BiH**

One of the greatest complaints in the formal SME sector regards competition from informal, unregistered businesses. By avoiding the tremendous costs of taxes, fees, registration, approval, labor regulations and other burdens, their costs are substantially below the costs of formal enterprises. They thus have the ability to undercut prices and drive formal SMEs out of some markets.

This problem is not being addressed from the standpoint of competition law, nor should it be. The current costs of formal business are ridiculously high, so that informal activity has become a survival strategy. Trying to force informal actors into the formal sector through increased sanctions will not work – and if it could work, the result on consumer prices and cross-border competitiveness would be devastating. The World Bank conservatively estimates that 36% of economic activity is in the

informal economy,<sup>35</sup> which is a stark indicator of policy and regulation gone wrong. The solution to reduced informal activity is to reduce the burdens on formal SME activity to levels that the market can reasonably sustain. This is being addressed through a number of projects, as discussed in the sections IV A, *Business Registration* and IV B, *Certificates, Approvals and Inspections*.

The problem of unfair competition through abuse of dominant position, price-fixing and “traditional” anti-competitive behavior has not received a great deal of comment from SMEs. The problem exists, however, and is being addressed in part by EU projects that focus on an improved competition law regime in harmony with EU directives.

The EU is also assisting with the reform of public procurement. While not directly a competition issue, government procurement represents a large and essential market in which SMEs compete against each other. Procurement integrity is vital for SME growth in this area, as well as for governance, rule of law, and economic development generally.

## Gaps

Compared with other areas examined in this report, competition issues take somewhat lower priority in the short-term. SME complaints about competition, as already noted, relate to unfair competition from the informal sector that cannot be addressed effectively through enforcement of competition laws. The fact that SMEs also complain about fair competition suggests that the priority gap at present is in understanding of the benefits and impact of more open competition. Such understanding will help to build the social foundation needed for the legal reforms and implementation that are required for an effective approach to competition.

*Poor Understanding of Competition.* As with so many other areas in this report, there is a gap in the public understanding of the importance of competition. The OECD Assessment highlighted some of the misunderstandings in this area. Several SMEs were quoted complaining about the lack of an SME strategy to *reduce* competition or the threat of competition. For example, one entrepreneur complained: “Several mills [were allowed to be] developed in a small area, resulting in very strong competition between them.”<sup>36</sup> In other words, the complainant saw the problem as one of *permitting* competition instead of enhancing it.

Adam Smith’s observations in America more than two hundred years ago still hold true today in BiH: “People of the same trade seldom meet together, even for merriment and diversion, but the conversation ends in a conspiracy against the public, or in some contrivance to raise prices.”<sup>37</sup> Popular understanding tends to worsen anti-competitive behavior and expectations for it is often focused on the jobs lost when one company goes out of business because of fair competition, instead of on the benefits to business and society in terms of cost, quality, and service as companies compete.

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<sup>35</sup> World Bank Report No. 24889-BIH, *Labor Market in the Postwar Bosnia and Herzegovina: How to Encourage Businesses to Create Jobs and Increase Worker Mobility*, November 4, 2002, p. 45.

<sup>36</sup> OECD Report, p. 20

<sup>37</sup> Adam Smith, *The Wealth of Nations*, vol. 1, bk. 1, ch. 10, 1776.

*Legal and Institutional Framework.* Much of the current donor assistance in the competition area is focused on passage or amendment of laws. While necessary, experience elsewhere suggests that few if any changes will result from passage of the improved legislation. Elsewhere in the region, competition agencies have found themselves under funded, understaffed, and undercut by political manipulation of the system in favor of entrenched interests. There is no reason to believe that BiH will not suffer similar challenges once the laws meet EU norms. Additional assistance will be needed to confront these challenges.

*Training and Education.* It is also clear that substantial education and training will be needed – especially through SME and business associations – to enable the market to respond effectively to these changes. Businesses will need to know their rights against violators of competition and procurement laws, as well as their new obligations under the improved legal regimes. A number of donors and stakeholders have noted that those involved in enforcement of rights need practical handbooks, explanations and guidelines to walk them through these new areas, as the law alone has been woefully insufficient as a source of knowledge.

## Recommendations

As with trade, public understanding is essential to creating support for changes in the competition regime. Although competition laws and anti-monopoly agencies can be imposed by the donor community, they will tend to languish in impact as has happened in Croatia and elsewhere in the region. It is arguable whether the existence of the laws and regulations has any significant positive advantage (other than checking boxes on the checklist of EU or WTO membership requirements) without public understanding that causes SMES and others to actually use the laws and institutions.

1. Identify areas of unfair competition as the basis for enforcement and public awareness. Popular understanding of competition in BiH focuses on the difficulties it imposes on a struggling business environment. Most SMEs would probably be pleased if the government would return to the old days and limit competition. However, many have discovered the difficulties created by *unfair* competition, which is the focus of competition laws and reforms. Currently, studies of unfair competition, with the possible exception of electricity and telecommunications, are not sufficient to effectively identify the presence and incidence of unfair practices. Such a study would be helpful to orient early enforcement efforts as the competition laws are put in place, and would provide a more solid basis for public education, especially through careful assistance to the business media.
2. Create a public awareness campaign on the benefits of competition. Public awareness and understanding are essential to change. The public must understand the problems accurately in order to support the solutions being proposed. Using the study just noted, create a public awareness campaign for SMEs regarding the impact of *unfair* competition and how to combat it. The “how-to” materials should include information on the agencies or governmental units responsible for enforcement and how they work.
3. Utilities Pricing. One of the strongest complaints from SMEs is that utilities are much too expensive (and irregular in provision) for them to absorb the costs

effectively and remain profitable. Over the long term, it is advisable to increase competition in this market, to the extent possible. In the shorter term, pricing should be regulated to emulate competitive pricing. The World Bank and others have extensive experience in regulation of these monopolies. SME development – and therefore economic development generally – would be well served by an imposed pricing regime that brings pricing into line with economic realities.

## **Labor**

Successful SMEs must be able to continually absorb the recurring costs of labor. These costs must be reasonably based on productivity and covered through pricing of goods and services offered in a competitive market. When labor costs are too high, SME growth will be stunted, resulting in fewer jobs. When costs are lower, SMEs are able to hire more employees if business growth requires such investment. It is worth noting that SMEs do not see increased employment as a goal – that is a social goal pursued by policy makers – but as an option to be exercised only when justified and demanded by market conditions.

Labor costs occur on several levels. First, minimum wage and social contribution requirements determine how affordable each new worker may be. From an economic perspective, higher wages should be related to higher productivity. Where these costs – wages plus contributions – are out of line with labor productivity, this results in lower profitability in SMEs and lower overall formal employment.

Second, labor regulations have a cost and risk element. Many SMEs face seasonal demands that require greater labor during one part of the year. If they cannot hire temporary labor, or must pay excessive severance pay upon dismissal, they may not be able to adjust, and will miss opportunities or turn to the informal labor market. Likewise, if regulations make it difficult to terminate employees – whether for cause or for economic necessity – SMEs will be very reluctant to hire additional permanent staff. They may fill gaps through temporary contracts with regular renewals, that allow them to by-pass restrictive legislation, but costing society the benefit of permanent jobs. Termination restrictions put employers at risk for long- and short-term costs that cannot be absorbed through price increases, significantly affecting their willingness to increase employment, even when market conditions justify new hiring.

Third, education and training affect labor productivity. When employees enter the job market with fundamental education and skills already in place, SMEs do not have to incur extensive costs of re-education or training, or do not have to enter bidding wars for the few candidates who meet their needs. In developed countries, public and private education are tailored at least in part to meet the needs of the employment market, ensuring that graduates have the minimum requirements that businesses supply. In fact, schools often compete to place their students successfully in the job market as a means of attracting quality students and quality teachers. If education is disconnected from economic reality, employers must shoulder the increased burden of education and training, often putting them at a competitive disadvantage with neighboring countries or the international market.

Finally, labor unions can have a negative impact on overall employment when their legitimate demands for proper working conditions and benefits are not balanced against the realistic ability of the market to absorb the costs. SMEs can fail completely when they are unable to negotiate reasonable costs because unions simply do not understand the economic impact of their demands.

## Current Situation in BiH

The FIAS study and recent studies by the World Bank show clearly that the current labor regime is damaging the economy of BiH through its unbearable burdens. Taxes and social contributions can exceed 70% of base wages, which the government attempts to control by setting various minimum wage requirements for various skills and professions. Labor legislation makes it difficult to terminate employees for any reason, thus repressing the ability of SMEs to hire the employees they would otherwise take. Evasion of the various requirements is extensive, with many companies openly declaring that they do not pay all contributions and turn to informal employment regularly to fill their needs. Much of the evasion is knowingly permitted by inspectors responsible for enforcement because it is well understood that no business can survive under the current system. (It is also well understood that it can be cheaper to pay an inspector an “unofficial fine” than to comply with the law, which is in part a function of unbalanced incentives.)

Some of the work being done in this area is from the tax side. Donor interventions are being led by USAID, GTZ and the EU to harmonize laws, improve collection and improve tax administration generally, including taxes related to employment. A recent study by USAID<sup>38</sup> pointed out the need to *lower* taxes and contributions related to labor, but a labor-specific project or reform initiative is not yet in place.

Labor unions and other labor representatives have had a considerable negative impact in the area of bankruptcy and bankruptcy law. Many existing or former state-owned enterprises have been unable to settle claims with workers who are no longer working, cannot be fired, and continue to hold on to escalating claims for wages and health benefits. At times, worker participation in management (through shareholdings under the voucher system) result in workers voting that any new capital coming into a company go first to paying off labor claims and, if anything is leftover, into ensuring the survival of the business through productive investment. High priority for “hidden” labor claims makes lending to SOEs and former SOEs expensive and unattractive. These problems flow directly from poor understanding of how businesses operate in a market economy, among other things.

## Gaps

The International Labor Organization is present in BiH and working with unions on various issues. However, no existing labor-oriented projects by any donor were identified that directly address:

- Reduction of labor costs through reform of minimum wage, tax or contribution laws
- Rationalization of labor regulation by eliminating mandatory hiring requirements and easing termination restrictions

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<sup>38</sup> *Toward an SME-Friendly Revenue System in Bosnia and Herzegovina*, February 2004.

- Public education for workers or unions regarding changes in the BiH economy and legal system.

These issues will continue to burden SMEs until addressed.

## Recommendations

1. Improved understanding of labor cost and productivity. Efforts to change labor regulations, minimum wages and various protections often run afoul of deeply entrenched misunderstandings of the relationship between costs and employability. The current structure is not protecting jobs, but actually increasing unemployment, but there is little evidence that union representatives or their members understand these implications. With informal employment constituting approximately 40% of all employment, it is clear that at least some of the workforce understands that they will not be able to get a job if they insist on the full panoply of legal benefits.

There is tremendous need for education of labor leaders and the general public about the cost issues of excessive protections. In part, this must be based on a new paradigm, for socialist ideology throughout the transition world has resulted in a skewed understanding that divorces salary from production, promotion from performance, and protections from economic realities of a poor country. As long as labor continues to insist on unsupportable benefits, there will be little reduction in the official unemployment rate. Consequently, a program of dialogue and education is needed, perhaps along the lines of Croatia's Tripartite Dialogue program, which brings labor, business and government together regularly to discuss their competing interests and how to solve them.

2. Revise the current Federation bankruptcy law. Not all of labor's resistance to bankruptcy legislation has been unjustified. Recent protests focused in great part on one unnecessary provision within the law. The provision reduces claims by employees to six months of *minimum* wages in the event of bankruptcy, not *actual* wages. This provision appears to be based on a misunderstanding of the needs of creditors. Creditors need to be able to identify and quantify potential claims against their interests so they can manage risks, not to reduce all potential claims. They can manage six months of actual wages just as well as six months of minimum wages. Instead of protecting the debtor and creditors, this provision increases the threats: employees will begin seeking new jobs immediately once their employer is in trouble rather than risk six months of drastically reduced wages. As the employment market improves, the existing law will make it difficult to reorganize troubled companies as their employees rightfully flee to other jobs. Revising the bankruptcy law would improve the law, but also improve relationships with labor for future changes.

## SME Access to Finance

To compete successfully in today's world, SMEs must have sufficient assets to fund new investment and sufficient income to meet their recurring obligations – to employees, suppliers, and tax authorities. SMEs can sometimes rely on their own resources – such as savings or income – to satisfy these needs, but when opportunities require greater resources, or when unexpected costs arise or revenues drop unpredictably, it is necessary to look to outside sources to cover the shortfall. For smaller needs, business owners can sometimes obtain financing through loans from friends and families, but eventually most SMEs need access to finance through banks, financing companies, and micro-credit institutions (MCOs) as well.

Modern market economies depend on healthy SMEs. As noted previously, SMEs employ more than two thirds<sup>39</sup> of the workforce of Northern Europe. For BiH to rebuild its economy, SMEs will need *reasonable* access to *affordable* finance for investment and working capital needs. Family and friends simply cannot provide enough money to power the growth required.

The availability of business finance depends on the ability of creditors – whether banks, MCOs, credit card companies, or even SMEs themselves - to balance their own costs, risks and revenues of granting loans and credit<sup>40</sup> at a cost to business borrowers that they can afford based on improvements to business achieved through the loan. For loans to be priced at 12%, for example, a bank must be able to cover the cost of lending for less than 12% and the borrower must be able to produce more revenue than 12% from the loan, otherwise it is not worth the trouble.

The principle concern for lenders is ensuring that the loans are repaid according to their terms. If risks of non-payment are high, they will charge higher fees and interest to cover the risks, or they will only lend to those with a proven capacity to pay and a history of repayments. When banks in a competitive market demand rates that are too high for most businesses to repay from reasonable business revenues, it is usually a sign that something is wrong in the risk side of the market. In other words, high interest rates or low availability are not problems in themselves, they are symptoms of a problem.

*High interest rates and low availability are not problems: they are **symptoms** of a problem.*

The problem of risk radiates throughout the finance system. Secondary lending – that is, loans made to banks so that they can in turn lend to customers – depends on the quality of the primary lending. If loans to SMEs are risky, secondary sources of finance will be damaged as well, because they must be based on the ability of the banks (as borrowers) to repay, which is based on the ability of the banks to collect from the SMEs

<sup>39</sup> [www.europa.eu.int/scadplus/leg/en/lvb/n26013.htm](http://www.europa.eu.int/scadplus/leg/en/lvb/n26013.htm)

<sup>40</sup> Loans and credit both enable a borrower to “buy now, pay later,” but they are different. With loans, the creditor provides money to the borrower, and the borrower uses that money to buy goods or services then repays the loan. With credit, the creditor provides goods or services to the borrower, who then repays the value of those goods and services. A variation is found in “lines of credit,” where the creditor (a bank) allows the borrower to spend money that is not in the borrower's account. Credit cards allow the borrower to obtain goods and services immediately, but the creditor pays the supplier, then the borrower repays the creditor. Finance institutions – banks, mortgage companies, leasing agencies, MCOs and others – may specialize in either loans or credit, or may offer both.



SMEs normally see the finance market on the basis of their direct access to loans and credit on terms they can afford for their business needs. What they do not see is that direct access – through banks, for example – is heavily influenced by indirect support that banks and other lending institutions depend on in order to provide financial services. A healthy environment, therefore, requires both healthy direct and indirect lending to ensure that SMEs get the credit they need. SMEs will not complain about poor financial market intermediation, only about the symptoms – limited access for their needs.

For Bosnia and Herzegovina, there are strong symptoms of an underlying problem. According to Principle High Representative Donald Hays, approximately 90% of the business representatives he meets express access to money as their primary concern.<sup>41</sup> The OECD Report notes that approximately 50% of SMEs interviewed felt that loans for working capital and new investment are difficult to get, plus there were strong sentiments that rates are too high. As of 2002, SMEs listed family or individual capital as their primary source of funds, with approximately 74% relying on this source for working capital and new investment.<sup>42</sup> This heavy reliance on personal sources of funding is in great part due to a perceived or actual inability to obtain affordable financing from banks, MCOs, leasing companies, and other institutions that provide loans or credit.

There is a debate in the donor community, however, on how much of a problem actually exists and in what segment of the market. Participants at the Roundtable noted that thousands of loans are being made to SMEs by banks and micro-credit organizations (MCOs) and that there is plenty of untapped capital available in the market for SME lending. It was noted that there is a gap for borrowers who fall between MCO and bank lending parameters: MCOs lend up to 30,000 km and banks typically lend a minimum of 50,000 km,<sup>43</sup> so that SMEs needing from between 30 and 50 thousand marks are not being serviced adequately. It is not clear, however, how serious this gap is, to the extent that it exists.

Other gaps have been identified that clearly do exist. a number of gaps have been identified. For ease of analysis, these are considered below in terms of direct and indirect access to capital. As already noted, SMEs complain only of the symptoms – whether they can get the finance they need at prices they can afford – which point to potential problems at both levels. The discussions that follow therefore focus on gaps in:

1. *Direct Access*, in which the lender provides finance directly to the SMEs:
  - a. Banks and debt markets
  - b. Micro-credit organizations (MCOs)
  - c. Leasing companies

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<sup>41</sup> Statements made by Rep. Hays at the SME Interventions and Gap Analysis Roundtable, April 7, 2004.

<sup>42</sup> OECD Report, pp. 28-32.

<sup>43</sup> Some banks have credit guarantees available through at least one donor program (of USAID) that provide guarantees for much smaller loans, down to 15,000 km. At that level, however, risk is not as big a problem as cost: the cost of making a 15,000 or 150,000 km loan is likely to be about the same, but the necessary fees are a much higher percentage of the smaller loan, making it unattractive to borrowers.

2. *Indirect Access*, in which a third party enables direct lenders to provide finance to SMEs by acting as a source of funds or agreeing to cover lending costs or risks so that funds can be loaned on better terms:

- a. Bank guarantees
- b. Pension funds
- c. Insurance funds

Gaps in indirect access affect secondary lending (described above), which is a major source of funds so that banks and others can provide direct loans to customers.

Pension and insurance funds are often loaned to or invested in financial institutions, allowing them to expand the credit they can make available in the market. Most people never see these activities or even understand them very well. As a result, surveys among businesses are unlikely to ever uncover specific dissatisfaction with indirect access to finance. Instead, complaints about poor direct access are usually strong indicators of problems with the indirect side as well.

The tremendous need for consistent economic growth and development in BiH through increased SME business activity makes it paramount that constraints to finance be removed or reduced on an expedited basis.

## Direct Access: Banking and Debt Markets

The primary point of contact between SMEs and capital markets is through banks and other lending institutions. Although liquidity and loan pricing are affected by innumerable influences, SMEs experience these in simple terms: whether they can obtain the finance they need at rates they can afford and on terms that meet their needs.

When SMEs complain about access to finance, it is tempting to assume that the banks are unreasonably withholding these resources. In a competitive environment, this is unlikely: banks make their own profits by lending, not by withholding. If they cannot lend at a profit to customers, they find other uses for their excess capital, such as European money markets. Likewise, if there is a problem in raising financing through debt markets, it is normally not because of a shortage of funds, but rather a scarcity of reasonable opportunities. If debt markets do not provide funding to banks (or directly to larger SMEs), it is usually because the risk is too high.

From a policy side, it is important to create an environment in which banks and debt markets can place their money in the local economy by lending to SMEs. One of the greatest constraints in transition economies is risk: poor legal infrastructure, uncertain political stability, and lack of enforcement mechanisms for loan repayment raise the price of credit, sometimes beyond the means of local borrowers. Risk always has a cost impact beyond the control of the financial institutions themselves. They can control internal costs, but external costs of risks require policy reforms.

### Current Situation in BiH

**Banking.** Confidence in banks as repositories for money has grown substantially under the numerous banking reforms and investments carried out over the past few years. This can be seen very clearly through the increase in deposits. Deposits tripled in the last three years and have grown an additional 20% in the past six months, going from KM 5 billion in September 2003 to KM 6 billion in March. This confidence allows the country to increasingly move savings out of mattresses and into banks, where it can be put to productive use.<sup>44</sup>

Much of this increased confidence is due to efforts of USAID and KfW, who, together with the Central Bank of Bosnia Herzegovina, created a deposit insurance fund in 2002. When people are concerned that banks may fail with their money inside, they will be very cautious about depositing their money there. Deposit insurance provides a guaranty that they will get their money back in the event of trouble, which is particularly important in a transition country with recent history of instability. The deposit insurance fund, which has been upgraded this year to a state-level agency, guarantees the deposits in its twenty-member banks (with 75% of their deposits insured). This has brought stability and discipline to the banking industry, while attracting greater deposits.

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<sup>44</sup> Not all of the increase in deposits resulted directly from increased confidence. When the Euro was introduced in Germany at the beginning of 2003, there was a large inflow of German marks, the cash of choice for much of the region. Some banks offered substantially better exchange rates for those who deposited their marks instead of merely exchanging them. The strategy was successful in attracting new depositors as well as increasing deposits by existing depositors.

Confidence by banks in local capacity of SMEs to repay loans appears less robust. Despite stated demand for long-term credit, most bank loans to SMEs are on a short-term basis. The Bank Agency figures for 2003 indicate that only 15-20% of the KM 20 billion in loans outstanding went to SMEs. Reserves on deposit with the Central Bank of Bosnia Herzegovina last year exceeded reserve requirements by KM 300 million.

This excess of reserves means that there is an oversupply of money in the banks that is not being loaned in the market. In light of the vocal demand of SMEs for greater access to capital, there appears to be a gap between supply of money and demand for loans. This gap is not due primarily to weaknesses in the banking sector, which is reasonably advanced for a transition country.

Improvements in the banking sector are impressive. Bank privatization is essentially complete (government ownership at end of 2003 was 13% of total capital in the Federation and less than 1% in the RS). Regulation reforms, funded by GTZ, USAID and World Bank, have dramatically improved the overall quality of the system. At the same time, weak or unprofitable banks have been reduced through substantial consolidation of the banking sector from 73 to 37 since 1998. Foreign investors have responded by investing directly in privatized banks as well as in new banks, such as Volksbank and ProCredit Bank. Bosnian banks are liquid and many have become profitable, with a significant (though incomplete) range of standard products. (See chart.) Export lending improved in 2003 through numerous small loans as EBRD assisted several banks to develop more robust trade finance capacity through letters of credit and similar services in support of exports and imports. Even so, the banking sector is still not meeting the reported demand for credit to SMEs.

Symptoms of the underlying problems appear in several forms. First, despite foreign investment and the presence of upper level foreign managers, most of the staff in existing banks still practice "traditional" investment analysis: instead of looking at a borrower's business plans, cash flow projections, and other commercial indicators of the borrower's ability to repay, loan approvals rely heavily on guarantors and high collateral requirements.

Low levels of analytical skills (particularly with regard to asset valuation) by loan officers and SMEs who present applications means that some loans are being rejected

FINANCIAL MARKET ELEMENTS		
Element	Attributes	Present in BiH
Senior Obligations	Government issued securities, low yield, highly secure	No
Interbank Market	Bank-to-bank lending for short-term liquidity, and improved earnings; better yield, relatively secure	No
Consumer Deposits	Largest source of funds, must manage terms and yields	Yes, through banks. Further product development needed.
Commercial Loans	Large, complex, relatively low risk loans, thin spreads	Yes, through banks. Limited to few, high asset borrowers; short term with high collateral.
SME Loans	Moderate sized, higher risk loan, higher spreads	Yes, through banks and MCOs. Limited to high asset borrowers; short term with high collateral and guarantors.
Commercial Paper	Commercial Securities, moderate to high yield, moderate to high risk	Theoretically. BiH companies can but do not yet sell commercial paper to raise capital.
Consumer Loans	Home Mortgages, Auto Loans, small to moderate sized, high risk, high spreads	Yes, through banks and leasing companies; short term with collateral and guarantors.
Non-bank Financial Institutions	Small to moderate highest risk, high spreads	Yes. MCOs; short term, various payback schemes, with collateral.
Institutional Investment	Cash-rich entities buy loan portfolios for investment returns	No. Insurance and pension funds are not being invested
Rent and Rent-to-Buy	More generous terms, lower risk	Yes, beginning, Leasing Companies

or overpriced. This pricing does not reflect the risk of non-payment, but the risk that the loan officer did not evaluate the loan properly.

Even with adequate analysis, however, banks demand high collateralization. Whereas banks in developed economies frequently finance up to 90% of a secured investment or purchase, in Bosnia, loan to equity ratios are more likely to be in the 30-50% range. As a result, assets that could be used to leverage additional financing are underutilized. For example, equipment worth \$100,000 might be used to secure a \$40,000 loan, with the other \$60,000 in value unusable for other loans.

These collateral requirements indicate a serious problem with risk in the legal framework. As noted in *Secured Transaction Environment*, page \_\_, there is a serious problem with enforcement of commercial obligations, especially foreclosure on collateral. Banks seek excess security to lower the risk of non-performance in light of the fact that the courts may not be able to compel performance. A number of projects are addressing this problem (and are discussed elsewhere), but it bears repeating that until these issues are resolved, few other improvements to the banking system will have any impact on lowering interest rates and improving loan to equity ratios.

The risks affecting credit terms in BiH are not only related to enforcement institutions, but also to the quality of the collateral being offered for security. Issues of ownership in land and real estate reduce the value of these assets, which is a direct result of problems in the cadastre and land registry offices. Lending against real estate – including homes – is a major source of funds for investment. According to the World Bank, personal residences account for 75% to 90% of household wealth in emerging market economies, and investment in housing accounts for 15% to 35% of aggregated investment worldwide.

Real estate is also a source of financing for banks and other lending institutions through the secondary debt markets. Banks package their real estate mortgages into bundles, then sell these bundles to investors. In developed legal systems, these are often quite attractive because mortgages are very low risk, and by selling the bundles banks can get immediate funding and let the investor take the 15-30 year payouts on the mortgages in exchange for In BiH, real property ownership issues are constraining development of business lending and debt markets. GTZ and SIDA are working to address these issues (see discussion in *Secured Transactions Environment*), but additional assistance is needed to put BiH on track for the economic growth and development needed over the next few years. Otherwise, real property will continue to be “dead capital.”

A number of projects are underway to improve the banking sector, but primarily from a regulatory, guarantee or lending standpoint. USAID, World Bank and GTZ each have programs to strengthen regulatory oversight of banks. USAID and GTZ are funding loan guarantee programs (discussed below in the Guaranty section), while EBRD, World Bank, the EU and GTZ all are providing lines of credit to banks for onlending. None of these projects, however, addresses the lack of risk analysis and loan officer lack of capacity that are resulting in poor lending practices and lost opportunities. There seem to be assumptions that foreign bankers will take care of this problem, but the rate of change to date is not keeping up with the need.

**Debt Markets.** Debt markets affect SMEs both directly and indirectly. Somewhat larger, more sophisticated SMEs use debt markets to raise finance by issuing bonds or commercial paper. Market rates on bonds, however, are heavily influenced by the

rates on government bonds, which create a benchmark for interest rates based on risk assessments. Thus government bonds have an indirect influence on the pricing and availability of commercial debt instruments. In addition, government and municipal debt offerings are frequently a source of financing for infrastructure and other public investments. Much of the work on the investments is carried out through government procurement in which SMEs compete for a significant amount of the total contract value. Thus these debt markets indirectly affect SMEs by funding work on government contracts.

There are several other indirect impacts of government debt markets. First, markets – private investors – set higher performance standards than are found in grants or donor funding. If a government wastes or misuses donor money, there may be political reasons to continue lending or otherwise clean up the mess. But if the same thing even begins to happen to private investors, they will simply stop buying the government bonds and prices for the bonds will drop precipitously. In order to obtain the best terms, the borrower must conform its performance to market expectations or suffer the consequences. This gives institutional investors (such as pension funds and insurance agencies) significant leverage in improving the overall business climate by insisting on the best standards. Debt markets thus create a measurable system of accountability.

Second, government debt markets provide immediate funding now without immediate tax increases, allowing government to avoid excessive tax increases. If the funds raised are invested in areas that produce increased revenues, then those revenues can repay the debt with no increase in rates. In BiH, tax burdens are already constraining SMEs and fueling extensive flight into the informal economy, thus lowering revenues. Use of government bonds can thus be an important tool for helping government rationalize the tax base and attract informal actors back into the formal sector.

These direct and indirect benefits do not exist for SMEs in BiH, because debt markets are essentially non-existent. There is no market yet for government, corporate, municipal or money market instruments. Most other governments in the region issue various bills, notes and bonds to raise finance, thus setting interest-rate benchmarks while managing tax burdens. The absence of such a benchmark makes it difficult to price other debt instruments, which in turn constrains development of the financial markets and economy.

Likewise, corporate and municipal debt markets do not function to provide long-term financing for capital infrastructure, either by public or private issuance. The Law on Securities is in place, which regulates the issuance of securities, including bonds. The procedure for issuing bonds is commensurate with that for issuing equity. But issuers are not prepared for the cost or process of complying with those procedures. This is a common impediment in the region that issuers and regulators are attempting to address in new laws and alternative procedures. In addition, without issuance of state securities, there is no benchmark against which to issue corporate or municipal securities.

US Treasury and OHR are assisting the government to develop and draft a framework law on sovereign debt to govern borrowing and lending at the state and entity levels.

This is a very important first step in BiH for the issuance of debt securities. This law will cover:

1. The process for due diligence
2. Issuance, settlement and trading processes
3. All other issues concerning the issuance of debt.

## Gaps

Priority gaps in banking and debt markets occur at several levels in the legal and institutional framework, but there is also a gap in the analytical base for policy development and project. On the legal side, the lack of a law on sovereign debt currently constrains debt market development, but this is being addressed. Of greater importance is the high level of risk faced by borrowers due to weaknesses in the secured transaction and enforcement regimes, because it affects all lending at every level. Additional risks and costs also arise from the institutional weaknesses in loan analysis and valuation. Together, these problems have an unacceptable negative impact on SME access to finance.

*Secured transactions and enforcement.* Gaps in these areas are covered in the *Overview* and the *Secured Transactions Environment* sections of this report. The importance of addressing these problems, however, cannot be overemphasized: enforceable secured transactions determine whether SMEs can have reasonable access to capital at affordable costs. Two aspects of the problems bear further mention here.

First, loan officers are not applying proper standards for determining value of collateral, whether movable, intangible, or immovable. As a consequence, they tend to both overvalue and undervalue assets offered to secure loans, or just ignore the issue and rely on guarantors for repayment, so that they rarely determine the reasonable creditworthiness of the guarantors. Changing the laws or improving the courts will not address the internal weaknesses in the banks' lending departments. A number of loan officers are receiving adequate theoretical and practical training in MCO programs, but this is not being reflected in banking practices. More assistance is needed, preferably through local institutions such as banking associations or other bank-related organizations.

Second, enforcement of commercial obligations becomes more difficult when sovereign obligations are not met. Failure of the government to pay its debts to SMEs means that SMEs are in turn unable to repay their debts to banks and suppliers. It also sends the wrong leadership signals to the market, suggesting that it is not important to honor contracts. While such "soft" impact is more difficult to quantify than the "hard" data on business failures, experience elsewhere suggests these leadership issues are very important for transition. The government must be challenged to honor its legitimate debts, and prosecute those responsible for its illegitimate debts.

*Analytical Base for Policies and Decisions.* The gap in analysis occurs at two levels. First is the policy side, where competing inferences from incomplete data affect direction of reforms for the country. Second, the private sector lacks analytical capacity for lending decisions. This is not just within the lending institutions, but within the SME community as well. SMEs and their potential lenders should first be

aware whether a loan is needed, and if so, whether the debtor can handle the debt, and how.

a. *Policy Analysis.* At present, most of the policy analysis on reform priorities is handled by the donor community, as local capacity is both limited and fragmented (scattered throughout different institutions). During the Roundtable, participant debates revealed a divergence of opinion on the current level of lending to SMEs. There was no consensus on whether lending levels are adequate, whether interest rates are too high, and whether there are enough funds available for lending. Some of the differences related to the perspectives of participants. Ground-level implementers who work with SMEs tended to champion the position that SMEs could not get sufficient loans. Implementers from lending projects tended to counter with statistics on how many thousands of loans are being made, and macro-economic specialists offered positions whether the economy could or should handle a higher level of debt. In short, each group provided analytical support for their positions, but their analyses were measuring different indicators that did not allow comparison or consensus. There is a gap in the data and analysis at the donor and government level with implications for appropriate prioritization and interventions.

b. *Institutional and Firm-Level Decision-Making.* A great deal of training is planned or underway for various stakeholders regarding changes in the framework laws affecting the banking sector. This is important, but does not address a greater need: understanding loan and risk analysis, risk management, and market-responsive lending. Investment by international banks has not produced a high level of skilled loan officers. To the contrary, even new investments have had to hire primarily from a pool of existing loan officers who have not been trained to today's international standards. They can best be characterized as "order takers" who passively await client applications. They then process the applications using outdated, inappropriate or poorly understood standards and techniques. Although there are certainly exceptions to this broad generalization, experiences related by local and foreign specialists identified several distinct gaps in the banking sector:

- Valuation: According to interviews for this analysis and discussions with Roundtable participants, very few people (loan officers, clients, evaluators, lawyers, judges, government officials and others) understand market concepts of They are unable to establish comparable values effectively for real property and seldom understand depreciation or production potential of equipment.
- Basis for Repayment: Loan officers do understand how businesses will repay their loans sufficiently to determine whether the level of debt being requested is reasonable, or whether it can be repaid. This gap partly explains the reason why they rely too heavily on collateral and guarantees – they reduce risk inefficiently (in the economic sense) through excess security because they cannot determine the level of appropriate security.
- Market Segmentation: SME needs are not the same. Each market – timber production, tourism, agro-industry, manufacturing, hotel management, professional services, and all others – has distinctive characteristics and business cycles, so that specialization is needed to serve the segments effectively. Banks are not developing these specializations adequately to meet the needs of the markets.



- SME Orientation: Banks lack experience with SME lending, leading them to conclude incorrectly that it is not profitable, which in turn leads them to decide not to develop the skills or markets.
- Passive Lending: Banking around the world has evolved over time in competitive markets from a passive, regulated transaction-oriented business to a pro-active, de-regulated, customer-driven business based on relationship management, not simple order processing. BiH has not evolved to the level needed by the SME market: it is still stuck in the past, passively waiting for applicants to come seek bank services, instead of pro-actively promoting new products and services.

Like banks, SMEs often lack the same skills and information, leaving them unable to present a convincing loan application, identify the nature of their needs based on their market profile, or even to determine whether a loan is necessary. Experience suggests that a significant number of borrowers do not need their loans, or not at the level being carried, if they implement good financial management skills that provide them better access to their own finances. Debt is not a goal, it is a tool for meeting business needs. Many SMEs end up in unnecessary debt for lack of other tools.

*Laws and Regulations.* Most of the legal framework is in place to support necessary development of the banking industry. Several items need to be completed or adjusted, however, to complete or improve the basic framework.

a. *Debt Markets.* The new law on sovereign debt is expected to be supported by training about the law. As different governments – national, entity, cantonal and municipal – begin offering debt instruments, there is likely to be a need for training the responsible officials about the implications of pricing (what it means if market offers discounts or premiums), how to respond to those implications, and how to ensure timely repayment. Moreover, debt financing should be done in the context of revenue rationalization, but there is still a gap in this area. (See the *Taxation* section page ?.)

b. *Regulations.* Roundtable participants noted that some banking regulations are not adequately supporting market realities. Specifically, the regulations prohibit long-term lending against pools of short-term deposits. Unless backed by guarantees, long-term loans may only be made against long-term deposits. However, a bank can place money from short-term deposits with a parent bank, which then provides the local bank with a long-term deposit based on the short-term pools, which then allows the local bank to make long-term loans. The existing regulations are intended to avoid liquidity crises (when depositors cannot get withdraw their money because it is tied up in long-term loans), but they so poorly, if at all, because of these “back doors” to the parent banks. The result is an unnecessary cost and a lack of long-term lending capacity in the market.

Foreign exchange controls create another gap in money supply. The fixed exchange rate makes it attractive for banks to deposit money offshore, instead of locally. From a policy perspective, this creates a misallocation of resources that could be better used as a source for local finance of SMEs.

*Public Education.* A number of interviewees and Roundtable participants noted that there is a lag between public impressions of the banking sector and actual situation. Many people – including many implementers – have not heard of the substantial improvements in deposits, deposit insurance, and stability. Participants also commented (as noted above) that much of the belief that banks do not lend to SMEs is a misconception. This suggests a lack of public awareness and education about these significant changes. As long as SMEs believe they cannot get loans, they will not try, thus missing valuable investment and business opportunities.

## Recommendations

The ability to tailor policies of the government, interventions of donors and services of the banks depends on competent analysis of local conditions in light of international best practices and benchmarks for similar countries. In other words, it is hard to know if policies, programs, and products meet the needs of BiH if we do not have a reasonable understanding of those needs. This analysis is important, but not a pre-requisite for all other interventions. There is broad consensus that banks do not have adequate risk assessment and credit analysis skills, nor do they sufficiently understand the different SME market segments from a lending standpoint. These skills lower both costs and risks of lending and increase revenues for a healthier banking sector through specialized, tailored product offerings. When SMEs have access to such products, it increases their ability to earn, enhancing economic development and stability.

1. Create a comprehensive, analytical base for bank lending to SMEs. Starting with a framework for macro- and micro-economic lending statistics, analyze existing studies to determine what else is needed for a better understanding of the lending environment. Having identified the gaps, fill them in. This can be done for different market segments (such as wood, tourism, and agri-business) as needed, but an overview should be prepared for macro-economic policy analysis to better determine country needs and risks. Each analysis can then be used for appropriate policy discussions and public education.
2. Training for Bank Loan Officers. Banks in BiH need to move from order taking based on mediocre analysis to proactive, market-oriented lending based on best practices in risk analysis and management. BiH needs to develop capacity needs for self-sustaining training programs through associations, schools, and internal bank training departments. The skills taught should include basic risk analysis, asset evaluation, loan tracking and financial management, as well as courses in marketing, promotion, and customer service. In addition, banks need to develop skills in serving market segments such as rural lending (45% of the rural market has no access to banking services<sup>45</sup>), as well as industries such as tourism. Rather than “pick the winners” by targeting a few banks for training, the program should complement market priorities by making services available then allowing banks to sign up for them.

Training loan officers is not enough, however. USAID alone has trained hundreds of loan officers and bank employees in practical skills, but they are not applying their knowledge when they get back to their desks. The problem appears to be one of

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<sup>45</sup> **SITE BUTLER**

incentives and leadership. The newly trained employees answer to managers who do not insist on using these new methods. The trainees are not rewarded or promoted based on their performance, so there is no reason for them to run afoul of managers who are not asking for the changes. Banking cultures are quite traditional, with a high level of hierarchy. Until upper level management insists on change, much of the training being given will be wasted.

3. Training for SMEs. SMEs need for improved skills is unlikely to be met effectively if it is not connected to their demand for loans. Working with leading banks, establish requirements for new loan applicants that they take certain courses in subjects such as financial management, receivables and payables management, collections, cash needs analysis and other appropriate courses to improve capacity of borrowers to repay responsibly. These courses can be offered by the banks or by outside consultants approved by the banks.

4. Develop Long-Term Loan Products. Evaluate and amend regulations as necessary to permit reasonable development of long-term loan products with 10-30 year maturities, especially for construction and mortgage financing. Although much of this development will depend on improvements in the secured transactions environment, regulatory improvement can run in parallel.

5. Public Education. In transition countries, the public generally assumes that high interest rates and poor access to finance is due to the greed of bankers. Under socialist ideology, banks have been demonized as exploiters for the better part of a century, and not recognized as legitimate service providers serving the basic needs of the economy. While monopolistic banking regimes lead to unnecessarily high costs and poor services, competitive banking increases access to affordable finance, but only if the costs and risks can be balanced against revenue requirements. Because of these misconceptions among government and society in general, there is insufficient pressure on government to solve the cost and risk aberrations of poor economic, social and legal policies that reduce access. Public education is needed to provide understanding of how the banking and finance system works, so that energies can be redirected to proper solutions.

## **Direct Access: Micro-Credit Organizations (MCOs)**

Banks cover the costs of providing loans through fees and interest rates. These costs include overhead costs of maintaining a bank branch, the salaries of tellers, loans officers and the rest of the banking staff, the cost of capital used to make loans, such as deposits, and the “risk reward” charged to cover higher risk loans. The basic cost of providing small loans can be just as high as the cost of providing larger ones, but as a percentage of the loan amount, the cost goes up as the size of the loan goes down.

SMEs often require initial investment capital for new ventures, which carry a higher risk. Banks, as fiduciaries of their depositors’ funds, are inherently risk averse, and so tend to charge even higher risk premiums for such ventures. Basic costs of lending plus high risk premiums (in the form of higher interest rates and fees) make small loans prohibitive for borrowers and lenders. Most modern banks simply cannot lend small amounts at a price rate that makes them attractive to borrowers based on their normal cost structures.

As a result of their cost structures, banks worldwide generally do not meet the needs of SMEs for smaller amounts,<sup>46</sup> leaving a gap in the market for affordable lending<sup>47</sup> to SMEs and micro enterprises (businesses with fewer than 10 employees). To fill this gap, various types of micro-credit organizations (MCOs) have developed over the past few decades. Much of the development has been driven and directed by the worldwide donor community, which has worked in multiple regions to develop innovative cost and risk reduction strategies so that the poorest of the world's population could have access to capital at affordable rates. This has been especially important for rural populations.

The models for establishing profitable, self-sustaining institutions have been based on subsidized start up costs, with donors and charitable organizations providing much or all of the necessary equipment, training and initial loan capital to MCOs, so that they only had to manage and cover normal recurring costs and risks. Along the way, they have developed highly effective and innovative risk management and cost reduction techniques that have allowed them to become fully self-sustaining.

Average repayment rates in the MCO industry are 98-99%, proving that they can successfully manage the high risk of lending to start up and small businesses. MCOs achieve this through a proactive approach that sends loan officers to the borrower's place of business to assist the borrower in completing the loan application and supplying the necessary financial data. This style of lending gives the lender the ability to see the business and test the validity of financial information. The borrower gets much more personalized attention than banks normally can provide, including basic education as borrowers work through the application process, and promotes a feeling of security when they apply for future loans.

MCOs experience a high level of repeat borrowers, which they encourage by increasing the amounts lent and lowering the interest rates after each successful repayment of previous loans. This procedure enables the startup business to enter the next level of becoming an established business with a history of creditworthiness, which should improve their chances of getting bank loans as they grow out of the micro-lending market segment.

Theoretically, MCOs finance SME ventures during their incubation stage, then banks take over financing once the SMEs are established. In practice, however, this does not always happen, for several reasons. First, banks are seldom willing to serve the areas where the borrowers are located, especially sparsely populated rural areas because their business model requires a certain level of customers met only in cities. Second, these "graduating" borrowers often lack sufficient collateral to secure bank

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<sup>46</sup> "Small" and "micro" mean different things in different markets. In India, for example, micro-lending can go as low as \$25, with average loans in a village staying well below \$1,000. In BiH, "micro" lending refers to amounts below 30,000 km. Banks in BiH seldom lend "small" amounts lower than 50,000 km.

<sup>47</sup> For the donor community, "affordability" is not just economic – it has a human rights element as well. In many countries, small loans are made by merchants and traders charging exorbitant interest rates taking years to repay for even the smallest amounts. Worse, these lenders sometimes demand payment through indentured servitude – especially child slavery – as a "risk reduction" technique. See G. Haugen, *Good News about Injustice*. One goal of MCOs has been to eliminate this market for loan sharks and servitude through economically self-sufficient lenders who can meet the demand without cost to human dignity.

loans, which are based on a secured transaction risk management model. Third, bank credit officers do not understand the financing needs of this target population, and thus cannot adequately analyze the credit applications. Without moving to a more proactive and innovative model of lending relationships, banks cannot meet the lending needs covered by MCOs.

MCOs do not take deposits, so they must raise funds for lending through other sources. Because of donor involvement in the industry, most initial capitalization is through grants or loans from donors, as well as guarantees to reduce the costs of borrowing from commercial lenders. Eventually, successful MCOs generate enough income from their loans to cover their costs and even repay borrowed funds, but this can take several years.

MCOs are crucial to economic development. In transition countries, where economies once based on huge state-owned industrial combines must rebuild through smaller enterprises, MCOs meet the needs of small entrepreneurs by providing access to capital at affordable rates below the lending threshold of standard banking institutions. These entrepreneurs are an essential engine for broad-based economic growth and development. Unless their needs are effectively met, development and growth will be stunted.

## Situation in BiH

The banking industry was barely functioning when peace returned to BiH in 1996. Banks were meeting few needs, particularly for the inherently risky entrepreneurs attempting to start new businesses. At this time, the World Bank conducted a survey and pilot project for entrepreneurs and discovered a high level of entrepreneurial activity among the financially disadvantaged and rural populations. Banks were not reaching these communities, especially in rural areas where 45% of citizens lived and worked. To address these needs, the World Bank developed a micro-credit program to meet the needs of these low-end borrowers.

The project has been remarkably successful. Originally, the World Bank intended for the project to provide between 7,000 and 10,000 loans of up to KM 10,000. After 8 years, the project has resulted in over 200,000 loans, with 51,000 active borrowers, which in turn have created or sustained over 200,000 jobs. The average loan amount has also increased each year and has always been substantially more than micro loans in other areas of the world.

Over the last eight years, more and more entrepreneurs started their businesses as a result of loans from the micro credit industry in BiH. MCOs (with the help of the World Bank and 27 other donor organizations) have developed a formula that meets the demand for funds for new and existing SMEs. Repayment rates on loans are normally above 98%.

The most successful MCOs have grown to the point that they are now constrained by law from meeting the needs of their larger customers. The current law places limits on certain terms, such as the amount of the first loan (KM 5,000), the total that can be lent to any one borrower (KM 30,000) and the maximum tenure of the loan (36 months). MCOs have developed the capacity to make larger loans for emerging businesses that fall outside these limits, but law prohibits them from using this

capacity. Banks are expanding their limits to SMEs, but generally set minimum loans at 50,000 km, so that there is a lending gap between MCO upper limits and bank lower limits. SMEs would be better served if MCOs could lend higher amounts for longer terms.

Ongoing demand for MCO loans to SMEs has been demonstrated by the speed at which the MCOs lend their funds. When USAID began making lines of credit available to MCOs, most of the recipients were able to lend out the full amount of KM 1,000,000 within 2 to 3 months. Larger MCOs even had a backlog of demand from their small business clients. The total amount of donor funds absorbed by the micro credit industry is over KM 100,000,000 today.

Planned funding by donors to the industry is currently being reduced. The World Bank, which represents 90% of the funding, announced that they will not provide any further capital after the current program ends (Local Initiative Program II) in June 2005. MCOs will therefore need to find alternate sources of funding. Many MCOs have borrowed from commercial banks, which apply traditional, unsophisticated analysis to this lending model, resulting in high interest rates and collateral requirements that MCOs cannot afford.

MCOs need sustainable funding at affordable prices, which is currently not available through banks in BiH. As a result the MCOs are investigating alternatives. One possibility is to convert some MCOs into deposit-taking institutions – banks – which provide a reliable source of lower cost funds. This conversion would enable MCOS to expand their existing services for the unbanked rural population, which many MCOs already serve with loans, but which banks do not currently serve nor plan to serve in this economy.

The current legal structure does not allow MCOs to accept deposits, however, the World Bank is supporting amendments to the present law that allow MCOs to transform from the current not-for-profit structure to a for-profit or membership structure. The UN is developing a new law that serves as a framework for savings and credit associations, which allows for deposit-taking with lower capital requirements than the banking law specifies. According to the USAID Savings Mobilization Assessment (October 2003), most of the larger MCOs would like the ability to accept deposits but are concerned about the difficulty of such a transformation. The assessment recommended a substantial amount of technical assistance over a period of two to three years in the areas of marketing, asset-liability management and cash security, among others.

Once the amended Law on Micro Credit Organizations has been enacted, the World Bank plans to introduce a law on Finance Companies. This will give MCOs an alternative structure to consider if they decide to transform from a not-for-profit to a for-profit organization. However, finding sufficient funding will continue to be a difficulty, in the form of both equity capital and long-term borrowings. An APEX type institution that funds on-lending activities for the MCOs could be an alternative solution, assuming funding can be secured.

## Gaps

The need for MCOs and their importance to the SME market in BiH is well established. Many of the MCOs serving this market, however, are not well established – they are still dependent on subsidized funding from donors as the mainstay of their own capital while growing towards self-sufficiency. In the future, they will need to have other sources of capital. Assistance will be needed to enable BiH to develop those sources and MCOs to use them. These gaps were identified as priorities by the Roundtable participants.

*Insufficient Range of Institutions.* Demands of the market and the capacity for sustainability both require that MCOs evolve beyond the current not-for-profit model. With changes in law (noted below), MCOs could become community development banks, deposit-taking institutions, and for-profit micro-finance companies. The not-for-profit restrictions threaten the self-sustainability capacity of many MCOs.

*Regulatory and Technical Assistance Constraints.* The gap in access to capital is due in part to the legal and regulatory restrictions on MCOs, because they are currently not permitted to take deposits. The World Bank is supporting changes to the law that would allow transformation into other types of institutions, but these transformations will not take place simply because a new law is adopted. Likewise, the UN savings and credit law will not create institutions, only the possibility that they can be created. MCOs will need extensive technical assistance to take advantage of these legal changes. The new laws should enable them to take deposits, serve as financing companies, and even raise capital through debt and equity offerings, all of which will require more assistance than is currently planned.

*Access to Capital for MCOs.* MCOs have proven their viability in BiH in terms of their ability to provide affordable funding to SMEs at reasonable prices. Some of the MCOs are now self-sustaining and able to maintain their current rate of lending. Current demand for such loans, however, exceeds the supply of funds available for lending. With World Bank reducing its direct and indirect funding, a gap is opening in the supply of dependable, consistent, affordable sources of funds, so that MCOs will require access to other sources of capital. This gap results in part from legal constraints on deposit taking as well as poor understanding of the market by traditional banks.

## Recommendations

1. Finalize the proposed changes to the Law on MCOs. Self-sufficiency requires that MCOs be able to provide for their funding needs through local and regional money markets in ways currently unavailable to them. The work of the World Bank with their MCO working group is crucial as a first step to long-term sustainability. The law should permit deposit-taking, transformation to for-profit status, use of debt and equity to raise capital, and additional product development.
2. Provide technical assistance for necessary transformations. As the law is developed, technical assistance is needed to prepare MCOs to take advantage of the new opportunities, first by informing them of the new possibilities, then by providing assistance and training to MCOs and other stakeholders to make the necessary transformations. The assistance should include analysis of MCOs interested in the various transformations, starting with examination of their financial health and

viability, then assisting viable MCOs identify their best opportunities and implement the necessary changes to achieve them. Training and assistance will also be needed for regulators to ensure that they understand any differences in requirements for MCOs and other lending institutions.

3. Make capital available through the transition period. It is likely that some MCOs will need financing to cover the costs of investment in making these transformations, as there will be a gap in self-generated revenues at start-up. This could be met through donor funding, but long-term sustainability requires a market solution. Assistance may be needed to identify existing sources of needed capital, and to work with traditional lenders to provide funding. The risk of these new ventures will likely result in higher costs of funding, which could be reduced through use of guarantees.

4. Assist existing lenders to understand the MCO market and meet funding needs. Banks in BiH currently require 30% cash deposits and other forms of collateral as security for loans. Inexperience in institutional lending to MCOs – including poor understanding of the MCO market – means that local banks use unnecessarily high pricing and collateral requirements to manage their perceived risks. Some of these banks may be prepared to develop new products based on market analysis and would respond to a program of technical assistance to help them develop funding products for MCOs.

5. Determine the viability of an APEX-type institution. The banking industry is supported in part by high-level institutions that specialize in providing funds to banks. It is possible that a similar type institution could be developed by and for MCOs through which they could raise capital through sale of debt or equity instruments to investors or by borrowing directly from banks. The institution could then lend these funds directly to MCOs or provide guarantees to other lenders to ensure affordable access to capital. If studies determine that such an institution is viable on a self-sustainable, market basis, steps could then be taken to provide technical support to establish such an institution.



## Direct Access: Leasing

Leasing is a specialized secured financing device used throughout the world to provide long-term financing to SMEs (and others) at affordable rates. It differs from traditional bank lending considerably. In loans, the borrower receives cash – secured by various collateral – which can then be used for various purposes, or even misused. In leases, the “lender” (lessor) actually purchases property and provides that property – not cash – to the “borrower” (lessee) to use. If the lessee defaults on the payment contract, the lessor can repossess the property more easily because it actually owns the property.

Leasing is attractive to lenders because of its simplicity, the greater security it offers to the lessor in relation to other creditors,<sup>48</sup> and the greater ease of enforcement through repossession. It is attractive to borrowers because it provides access to needed physical assets through long-term contracts at reasonable prices. In some countries, it has added advantages because of tax considerations that further lower prices. Leasing has become a critical source of finance for SMEs in every economic sector: business, manufacturing, agriculture and consumer sectors. It is one of the principle foundations of lending in developed markets (accounting for 30% of long-term financing in the OECD countries, for example),<sup>49</sup> and plays an increasingly important role in transition economies.

Leases are often available to businesses that do not meet criteria for ordinary loans, especially in cases where the borrower has no credit history or collateral. The principle difference between leasing and traditional loans is ownership. Under traditional loans, a lender provides funds to a borrower, who in turn purchases equipment or other assets and becomes owner of those assets. The loan is repaid over time, and the borrower maintains unbroken possession and ownership rights. The loan may be secured with the assets – so that the lender can take the assets in event of default – but as a creditor, not an owner.

In leasing, the “lender” (lessor) actually purchases the assets on behalf of the “borrower” (lessee) and is the legal owner of the assets. Under the leasing agreement, the lessee has the right to possess and use the assets, but not to own them. If the lessee defaults, the lessor takes possession of the property as owner. Because of this ownership aspect, authorities are more willing to permit and assist with repossession of the property, even in countries where the enforcement system is generally dysfunctional, such as Croatia.

Leasing is a hybrid between rental and borrowing. Most leasing transactions in business are a form of financing, where at the end of the lease the lessee actually obtains ownership of the assets. As a result, the lessee obtains equity in the assets. In other words, the leasing company is a fiduciary, holding ownership on behalf of the

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<sup>48</sup> Lessors are treated as creditors since generally they have similar rights to other creditors. Both give a valuable asset (leased property in case of a lease and money in case of creditor) while receiving payment for the use of this asset over time. Both face risk of the user of the property granting rights to third parties.

<sup>49</sup> Leasing in Emerging Markets, International Finance Corporation, 1996. (Available at [http://www2.ifc.org/publications/pubs/loe/loe3/ese\\_3/](http://www2.ifc.org/publications/pubs/loe/loe3/ese_3/))

lessee until the full amount is paid. This becomes important in the event of repossession. In many leases, the lessor can repossess the property, then either keep it or sell it, but may have to repay some portion of the equity to the lessee for investments made. As a result, leasing lowers risks both to lenders and borrowers. For SMEs, this is often the best or only source of financing available for equipment purchases.<sup>50</sup>

## Current Situation in BiH

BiH's leasing industry is growing at a very rapid rate because leasing is so effective at lowering costs and risks. Despite general problems in enforcement, leases are easier to enforce and carry lower risk to the lessor. In addition, they do not require the same level of documentation as traditional bank loans. Thus a number of foreign financial institutions are introducing leasing products to BiH.

The growth has come despite the lack of a leasing law. Instead, leasing companies rely on existing obligations laws, which recognizes their ownership of the leased goods. Currently Hypo Leasing holds approximately 60% of the market share, while VB Leasing, Raiffeisen Leasing, and Euroherc Leasing (an extension of an insurance company) hold the remaining share. The announced entry to the market of Unicredito Group Locat Leasing and HVB Leasing will bolster competition, which may result in lower lease costs for SMEs.

Vehicles, including private cars, commercial vehicles, and rolling machinery, account for approximately 70% of all leasing transactions. Equipment and other machinery leases make up the remaining 30%. Approximately 70% of lessees are companies, and the remainder are private citizens. Annual leasing transactions are estimated at approximately KM 150 million. Some leasing companies are estimating 50% sales growth in 2004.<sup>51</sup> It is estimated that growth would be even greater if tax disincentives could be removed. Currently, leasing companies cannot treat the purchase of equipment to be leased as a cost, so that they pay taxes on the purchase and when they lease the equipment. In most other countries, this double taxation has been eliminated.

Currently, the leasing market is unregulated. It has developed under general principles of contract and property law, without an actual leasing law in place. It is preferable to have a specific law in order to deal with complexities and avoid legal conflicts that will eventually arise, because the existing base is inadequate for full development of the industry. However, leasing is a subset and integral part of the secured financing system, and cannot be developed without reference to the numerous complexities of the secured financing legal framework.

GTZ<sup>52</sup> and SEED have recently drafted different laws affecting leasing. The SEED draft law was prepared without proper attention to certain secured financing issues, and in draft form unnecessarily threatens to restrict or eliminate several secured

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<sup>50</sup> On USAID's Business Finance Project, 6% of the funds advanced were used for equipment purchases.

<sup>51</sup> Statistics taken from Leasing Sector presentation given by Steve Hackett at the *International Investment Conference in Bosnia and Herzegovina*, held in Mostar, March 26-27, 2004.

<sup>52</sup> GTZ included a general chapter on leasing in the Law on Obligations. SEED has drafted a stand-alone leasing law.

financing mechanisms. The Bulldozer Committee Phase II is promoting the SEED draft law in a set of laws that it is attempting to push through. During the Roundtable, however, participants were able to identify conflicts and have since formed a working group to resolve the problems. USAID has been involved in these discussions as well to ensure that the leasing law does not negatively affect other secured transactions being developed under its Pledge Registry Project.

## Gaps

Various gaps affecting leasing are addressed in the Section V of this report, under *Secured Transactions Environment*. The following priorities were also identified by Roundtable participants. Legal harmonization was clearly first, but tax issues can be addressed simultaneously.

*Problems of Harmonization.* Leasing is an essential component of the financing regime for SMEs, allowing them access to capital not otherwise available. The leasing law, however, is only one aspect of the secured transactions regime, and must be developed in harmony with other secured transaction mechanisms. The current draft must be harmonized with the law on pledge or it will damage the overall secured transactions framework as well as the law on obligations. This issue is more fully explained in Section VC, *Secured Transactions Environment*.

*Tax.* Current tax laws result in redundant, overlapping taxes that should be eliminated. The introduction of VAT will improve the situation somewhat, but will not eliminate problems related to recognition of depreciation on leased assets. These burdens add to the overall price and thus to the overall cost structures of SMEs. As stated elsewhere in this report, the costs of formal business activity on the whole are too great for the economy to bear: this is just one of many that can and should be reduced.

## Recommendations

Extensive recommendations related to harmonization of laws can be found in Section II, *Overview* and Section VC, *Secured Transactions Environment*, along with additional recommendations affecting leasing. Only the following priority recommendations are offered here.

1. Establish a common donor approach. A number of donors have been working on various aspects of the leasing law, but not always with sufficient knowledge of what the others were doing. Those involved in leasing, particularly SEED, USAID and GTZ, should develop a common approach with clear understanding of responsibilities for the work.
2. Analyze and amend tax regime affecting leasing. With the numerous tax changes being proposed throughout BiH, it is not safe to assume that leasing will automatically be taken care of through other reforms. A specific analysis should be made of the existing and proposed VAT regimes and their impact on leasing costs and profitability. Once analyzed, a specific leasing-oriented proposal should be made, with due regard for other tax changes, that specifically identifies tax reform needs of leasing companies and their clients.

3. Analyze need for public education on leasing. Several implementers have suggested that public education is needed for SMEs so that they can better understand the advantages and availability of leasing for their business needs. In the highly competitive leasing market, however, it is not clear that the leasing companies will in fact leave a gap in this area. Aggressive advertising, paid for by the leasing companies, is quite likely to provide most if not all of the public information needed. There may be segments of the market not covered, however, such as rural areas that could benefit from equipment leasing. Rather than mount an information campaign, it might be better at this point to determine whether any segments are being neglected, then develop targeted information campaigns for them.

## Indirect Access: Loan Guarantees

Loan guarantees are promises by a third party (guarantor) to repay a loan in case a borrower defaults. There are two basic reasons that a borrower might need a guaranty: either the borrower is not creditworthy (having a bad credit history or no credit history), or the cost of the loan is too high for the borrower to afford because of risks involved. In the both cases, the guarantor lowers the risk to the lender, either by providing a creditworthy borrower as back up for the primary borrower, or by lowering the risk sufficiently to enable the lender to lower the price.

SMEs often depend on loan guarantees, especially when they are first time borrowers or need financing for a start-up company. As a general rule, banks worldwide do not finance start-up operations. Larger companies may be able to access venture capital – investors who will take a risk on the start-up in return for a share of the company – but this is often difficult for the lower end of SMEs.

These guarantees can be direct or indirect. In direct guarantees, the guarantor is normally a person or company that knows the borrower and agrees directly with the lender to assume the risks of repayment if the borrower defaults. Indirect guarantees occur at the institutional level. For these, an institution will agree to cover the risks of an institutional lender taking on certain types of lending. This is often used to done to pursue government policy in developing a segment of the economy. For example, governments worldwide frequently provide guarantees to banks that finance exports in order to lower the costs of trade finance and stimulate export growth. In other words, guarantees provide for reasonable access to finance at affordable costs. In SME development, donors and government offer guarantees to banks to lend to SMEs at rates that would not otherwise be affordable. While normally this represents a justifiable economic subsidy to stimulate growth, that does not always have to be the case. Private sector institutional guarantors also exist that specialize in a field of lending and so are better able to assess risks than individual banks. They will provide guarantees at a cost to the borrower, but a cost that is cheaper than the risk premium offered by banks. In that way, guarantees can become a self-funded, self-sustaining commercial service. More active donor and government involvement is needed, however, when overcoming difficult periods of transition if the market does not respond rapidly enough to meet the development goals.

## Current Situation in BiH

The banking system of BiH was in disrepair with very little lending available for SMEs when donors first began addressing economic development issues in 1996. As a result, direct loan programs, such as those of USAID's Business Development Program and International Finance Corporation, provided loans to rebuild businesses destroyed during the war or those that needed capital to restart. As the banking sector improved, direct loans were replaced by lines of credit for on-lending lines of credit by local banks. In the next phase of the banking sector assistance, loan guarantees were introduced.

Roundtable participants have highlighted the fact that such programs should not be confused with government or private sector guarantee programs. Donor guarantee programs have a specific purpose, finite funding and limited duration. The programs were developed in response to a distorted financial system, including design flaws

such as outright prohibitions of long-term lending based on short-term deposits. (See discussion of *Banking and Debt Markets* for further discussion). As a result, SMEs have been unable to obtain long-term funding needed for investments such as construction, with banks rarely giving more than 12 months for repayment instead of the industry standard of 60 months or more.

There are currently three guarantee programs operating in BiH: USAID Loan Guarantee Program of the Development Credit Authority (DCA), Kreditanstalt für Wiederaufbau (KfW), and Investment Guarantee Agency (IGA) funded by the World Bank Group. Two additional organizations, European Union Regional Economic Development (EU RED) and Swedish International Development Agency (SIDA) are considering starting similar guarantee funds or projects but the development of those is still far from practical implementation.

Supported by the Development Credit Authority, USAID partnered with three commercial banks to make resources available for investments in SMEs that support development objectives. USAID guarantees half of the loan made by the lending institutions. As a result, a small amount of USAID development assistance funding enables the local banking sector and other sources of private capital to take on projects that otherwise would not be funded because of high risks. The goals of DCA are two-fold: (1) to mobilize private capital to finance SME development initiatives abroad, and (2) to demonstrate the economic viability of such investments to the local banking sector and to other sources of private capital.

USAID in BiH entered into loan portfolio guarantee agreements with three local partner banks. USAID signed the agreements with the banks in September 2003. These agreements state that USAID will provide the partner banks with a 50% guarantee on loan principals extended under the terms of the agreements. The banks will use their own funds and credit review process to fund and approve these loans. These loans are intended to provide both long and short term financing for Bosnian private enterprises in agricultural production and processing, wood processing, and tourism. Through this DCA program the banks have the opportunity to lend their short-term funds long term. But these loans are exempted from the law (even though only 50% of the loan is guaranteed). The total loans extended under the guarantee program will be US\$31 million. Minimum loan amounts that will be qualified for this guarantee will be US\$15,000 and the largest loans will be made up to US\$2,000,000. The banks will have a 4-year period to use the guarantee, and the guarantee coverage will last for 7 years.

KfW has issued guarantees to two banks for a total of €7.5 million. The total amount of loans covered by this guarantee program is currently €50.3 million, which covers SMEs, housing, reconstruction, and infrastructure. SMEs directly receive a portion of €10 million. The bank loans to SMEs are generally from KM 50,000 up to KM 100,000, and may include start-ups.<sup>53</sup>

IGA is issuing 15-50% guarantees solely to export oriented businesses in BiH. Guarantees are issued with IGA's charge of 2.5% cost on annual basis with average €250,000 guarantee amount.

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<sup>53</sup> ProCredit Bank, which started as a micro-credit bank, sometimes loans amounts as low as 10,000 km as well, but few loans are made at this level by banks.

## Gaps

The vibrant donor involvement in the guarantee market underlines the gap in market responses. The programs have not induced banks to develop long-term loan products or otherwise step into the market decisively. The gaps below represent priorities of the roundtable participants.

*Timing.* Credit guarantees are a new concept in BiH, introduced by donors within donor programs. Although the foreign banks that have invested in BiH banking are familiar with this product, they have not yet had significant influence on local banking practices and culture. At this point, the programs are still quite new so that it is difficult to measure their impact and use that impact (assuming it is positive) as the basis for replicating the programs for government and private sector initiatives. There is need for careful monitoring and dissemination of results.

*Public awareness.* SMEs are aware that banks often require guarantees, but not generally aware that it is possible to qualify for institutional guarantees to replace the collection of friends and family that too often must be rounded up to support loans. Consequently, they do not know to seek such guarantees or demand them from banks or government. Instead, they incur the extra costs and inconveniences of personal guaranty requirements. At the same time, local banks are also unfamiliar with many of the credit guarantee possibilities available to them and their customers, or how they could use guarantees to develop additional products. Without clear bank demand for (and acceptance of) guarantees as a tool for their profitable expansion, they are unlikely to create conditions for private-sector guarantees.

*Market distortions.* Donor initiatives always run the risk of distorting markets through subsidized products, finance and services. This distortion is often justified in order to accelerate development or create secure conditions for growth, but it cannot be ignored. Distortions can be mitigated through careful planning and program adjustments. There are currently several potential dangers from existing program assistance:

- a. *Wrong messages.* One important development goal of guarantees is to bridge a gap in the market until private sector commercial replacements can develop. Guarantees allow banks time to develop expertise in these subsidized areas as the banking environment matures and develops. In theory, at least a few banks should develop affordable pricing for export finance or construction loans, for example, so that they can continue lending in these sectors after the guarantee programs are over. Unfortunately, what banks often learn in practice is that such lending is profitable if someone will subsidize their inexperience and lack of expertise by providing guarantees, so that their lending disappears when the guarantee program ends. It is not yet clear which message banks are learning.
- b. *Reduced pressure.* Guarantees reduce risks to banks, but they do not necessarily reduce the actual risks. In some cases, risks are actually overstated, such as when banks do not understand the cyclical nature and needs of agriculture financing, for example. In those cases, guarantors that specialize in those risks can provide a more realistic assessment, then charge their clients a reduced rate for covering the excessive risk reward being charged by a bank. But when the risks are properly understood and priced accordingly – such as poor enforcement – guarantees do not solve the

enforcement problem, but only the lender's part of that problem. An unintended negative consequence of this is that guarantees can actually reduce pressure for change, because those most effective at advocating change (banks) do not need to do so as long as the guarantees are in place. Consequently, guarantee programs should be designed to replace that market-driven demand by advocating reforms to reduce the risks they are covering. Otherwise, it will not be able to replace subsidized guarantees with market-based providers, or to reduce the overall economic cost of the problems that have justified the guarantee schemes. It is not clear that current programs are involved in such advocacy and reform.

*Confidence in government.* It is a simple fact that governments around the world use guarantee programs for economic policy purposes. For example, many governments have export guarantee programs to stimulate export production with their consequent foreign exchange earnings. Current donor programs represent initiatives frequently undertaken by governments, and should be transformed eventually into government programs, to the extent they are still needed (and not viable on a market basis) when the programs are over. However, there is a great deal of distrust of government by the general population, and a fear that any national funds would be used for unjustified political purposes. The World Bank's PRSP encourages the use of loan guarantees in its package of development tools, but these should be institutionalized on a permanent basis. There do not appear to be any programs addressing institutionalization with appropriate controls.

## Recommendations

### 1. Create a database for supporting (or reforming) additional guarantee programs.

The private sector will not issue guarantees unless it is profitable to do so. If it is profitable, then there are investors who will be willing to enter the market for providing guarantees. Likewise, responsible governments will not offer guarantees unless it can be shown that they achieve the development purposes for which they are designed. Both of these issues can be addressed through proper collection and analysis of statistics and economic indicators affected by the guarantees.

Current programs are already developing a valuable base of statistics and impact assessment information. It is not enough to use these for tracking program success: this information can be used for advocating evolution to the next phase of development. Targeted guarantee funds – such as guarantees for cluster development as the wood production industry – should include an analysis and advocacy role to show private sector investors that such services can be profitable. (Assuming, of course, that they are. Otherwise, ongoing support should focus on government involvement.) Statistics should be developed for and within each program, and then compared and analyzed as well on a country-wide bases for all programs. Data should include:

- Results for each bank receiving guarantees, including:
  - o Loans made
  - o Jobs created (by type of loan; e.g., short- versus long-term)
  - o Default rate
  - o Reasons for default
- Results for each guarantee program, including:
  - o Total costs of the program



- o Costs per loan
- o Profit or loss if transformed to a for-profit program
- o Economic impact, including job growth, increases in exports, etc.

Within three to four years this data will begin to tell a story that can be used for advocating appropriate next steps.

2. Implement a program of advocacy and public awareness. As noted, both borrowers and lenders are often unaware of guarantee programs that could benefit them, resulting in lost opportunities and insufficient demand to sustain non-subsidized programs. At the same time, many of the existing and planned programs work with numerous stakeholders within their target markets and are uniquely qualified to orchestrate appropriate awareness campaigns. Moreover, numerous programs providing training and other assistance to SMEs are also uniquely situated to disseminate guarantee information to their stakeholders. Each program should therefore include public awareness and information dissemination as one of their tasks, then track increases (if any) in the demand for or use of the guarantees by their targeted stakeholders.

Guarantee programs must also take an active part in advocating reforms in the business environment by identifying necessary reforms and advocating change. These programs act as an anesthetic to those who might otherwise advocate changes: with guarantees, banks do not have to worry about risks and borrowers get loans they could not otherwise afford, so they have no reason to complain. Once the guarantee programs are gone, however, the environment may be very much the same, unless the programs help to identify and address the problems that led to their creation in the first place. These programs are well staffed by experts who understand what changes should be made to reduce the risks, but unless required to focus on change, much of this expertise will be lost. Each program should therefore include an advocacy component, working with and through private sector and government counterparts to reduce risks through legal, educational and other reforms.

3. Develop an APEX-type guarantee institution. Rather than start another development bank as suggested by some Roundtable participants, it might be more appropriate to establish an APEX-type institution, owned and funded by local banks and equity investors, that could specialize in various debt guarantees. If viable, this would also provide additional market discipline by creating performance-based incentives with competitive impact. For example, the institution would price guarantees not only based on risk, but based on financial management capabilities of the recipient bank. If a bank had a high default rate leading to a higher cost, then the bank would have to improve its management to stay competitive.

## Indirect Access: Insurance and Pensions

Most SMEs are unlikely to know of or understand the connection between their finance needs and the insurance and pension industries. However, money generated by these funding sources in the United States and Europe constitute up to one third of financing needs through investments in the financial markets. Insurance policies and pension funds receive premiums and contributions on a long-term basis, and are therefore by their very nature good sources of long-term financing to businesses and banks.

In countries with a well developed banking sector, banks package and sell their own loan portfolios to investors in what has become known as the “secondary market.” These portfolios can be based on long-term or short-term loans. By selling the portfolios, banks can exchange future earnings for present funding, which they reinvest through additional lending and investments. If the secondary market is well established, a bank can make long-term loans against short-term deposits, because it can sell those loans well before they mature and replenish any funds needed to pay depositors.

Investors benefit because they can buy the portfolios at a discount<sup>54</sup> and receive income for a profit at a set rate over the life of the loans. Insurance companies and pension funds, called institutional investors, have a constant supply of long-term money from their premiums and contributions. They tend to make conservative investments to ensure an adequate profit margin and sufficient funds to meet their pay-out needs. For them, loan portfolios are an excellent, conservative investment that allows them to put long-term funds into long-term investments. If they need have to convert these investments back into cash for some unexpected reason, they can easily resell the portfolios.

SMEs may not notice direct connection of insurance and pensions to financing, but they do notice the connection to business. Pension payments are a cost borne by business through social contribution made by employers on behalf of their employees. If too high, the pension contributions can be a serious drain on resources for additional hiring or better labor productivity, especially if other taxes are burdensome. Insurance products can have a second indirect benefit to SMEs seeking capital. Well developed insurance industries offer insurance against numerous risks for both banks and borrowers. With proper insurance, a bank may lower lending rates by having their risks insured or by requiring borrowers to insure against risks on the bank’s behalf.

Insurance companies also bring discipline to the markets and pressure for reform of the courts. Discipline comes through adjusting premiums to the performance of the insured. Insurance clients who lower their own risks through prudent management and practices find that they pay lower premiums over time. In addition, insurance companies are principle enforcers of a number of rule of law and commercial law issues. They make sure that stolen cars really are stolen, that fires are not arson, that

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<sup>54</sup> The discounted price is based on several factors. The main pricing calculation depends on differences between the present and future value of money at the time of the purchase. In addition, there may be a risk discount for certain types of higher risk loans. The banks thus lower their risks while replenishing their funds.

safety standards are put in place, and they can have tremendous impact on the overall business climate by helping to establish a manageable risk structure, which releases assets into the financial system. This benefit is indirectly related to SME access to finance, having a positive impact on the overall business and financial climate.

## Current Situation in BiH

The **insurance** industry is in its infancy in BiH. There are few market-driven products available that normally support finance in developed markets, such as business risk insurance, credit risk insurance, and hazard insurance, among others. Foreign institutions have begun to introduce products into Bosnia, such as automobile and life insurance. Total premiums in the insurance market in 2002 amounted to KM 265 million, only a small percentage of what can be expected as the industry develops. However, even this amount provides substantial resources for investment.

The 10 largest insurance companies in Bosnia hold 70% market share and most policies are written for auto and third party liability. It is suspected that insurance premiums are departing the country through sales by non-registered (foreign) insurance companies who hold premiums abroad and invest them abroad. However, the environment has not been conducive to reinvestment locally, so the complaint about “taking premiums out of the country” is a bit disingenuous. There is also anecdotal evidence that citizens have very little trust in domestic insurance companies.

At the state-level, the Ministry of Finance and Treasury oversees the insurance sector. The Ministry of Finance in each entity also claims insurance supervisory authority, but the Federation has delegated this function to the Insurance Supervision Authority. In reality, the insurance industry is not effectively regulated nor supervised. There is no recourse to an insured if the claims are not paid.

The EU has drafted laws governing insurance supervision to create a single economic space, supported with laws that converge with the EU legal structure. The draft law will create a state-level insurance agency, responsible for ensuring congruency between entity supervisors, EU convergence, and conciliation of inter-entity supervision disputes. In addition, the EU is planning to launch an actuarial education project.

Due to the weak status of the **pension** system in BiH, life insurance is being used as an alternative to long term savings normally accumulated in private pension funds.

Pension reform advisors with the World Bank and USAID both indicate that the development of the private pension market is significantly behind other countries in the region. In addition, this market has no champion promoting reforms at the entity or state levels, and will take several years to accumulate significant assets.

The World Bank is leading the reform of the pension sector in BiH with limited progress. Recently, pension contributions were forced to undergo cash rationing, but the situation is now improving and rationing appears to be somewhat under control. Large budget transfers to the entities are still needed to cover special pensions for certain categories of citizens.

BiH needs major structural reform of the mandatory “pay-as-you-go” system.

According to one World Bank advisor, it is unrealistic to expect Pillar II reform (mandatory contributions) within the next 7-8 years, but Pillar III reform (voluntary contributions) could occur before then.

Public and private pension funds and pooled insurance proceeds need high quality assets for investment purposes. Currently, there is no debt market or other source of high quality investment for these assets in BiH.

## Gaps

While leasing and insurance both have significant developmental gaps, there are a few that can be addressed effectively in the short or medium term to enhance SME access to finance through secondary financial markets.

*Pensions.* Long-term pension reform is needed, but is outside the scope of this report. At present, pensions are in survival mode. Low confidence in the system and high overall contribution costs have led to extensive evasion of pension contributions by employers, with payments made based on understated salaries. Pension fund analysis is poor, with completely inadequate planning for future payouts. In the short-term, pension funds will not contribute to SMEs development in BiH. It should be noted, however, that private pension funds in Bulgaria and Russia are the single greatest driving force behind the creation of secondary markets for mortgage loans. BiH has much to do at many levels before such markets can develop effectively.

*Insurance.* Insurance is not effectively regulated, despite having basic legal structures in place at state and entity levels. Some lending institutions have been effective in requiring insurance policies from their borrowers, but most of the policies are being purchased from unregistered, foreign companies whose performance cannot be regulated locally. This lack of proper regulation capacity increases risk of non-payment of claims in theory, but this had not been received significant complaints in practice.

There are few forms of business risk insurance available. Even so, the insurance environment needs to be developed to provide reasonable coverage for business risks generally, while also improving SME access to finance. In addition, public awareness of insurance products and their benefits is low, other than mandatory insurance for automobiles.

## Recommendations

The long-term nature of reforms in insurance and pensions puts most recommendations outside the scope of this report, which focuses on interventions that will have an impact in the short and medium terms. These are limited.

1. Establish the legal and regulatory framework for insurance. The representative of a foreign insurance company has reported that the company is ready to enter the BiH market as soon as there is a proper insurance law and regulations in place. Development of the legal framework, including improved insurance law and regulatory system, are fundamental elements in attracting quality insurance offerings.
2. Public awareness of new and existing insurance offerings. As insurance products for reducing lender and borrower risks develop, it will be necessary to create awareness. Awareness campaigns should educate SMEs on the role and utility of insurance and how it can lower business risks. Much of this work will be done automatically by insurance companies, who will want to advertise their products in order to increase sales. However, there is likely to be a gap in overall understanding

of insurance that constrains purchases, which may justify donor support of a broader insurance awareness campaign.

3. Develop the BiH debt markets. As noted in *Banking and Debt Markets*, above, there is a great deal of work to be done in developing debt markets so that pension funds and insurance companies have an outlet in BiH for investing their funds. Otherwise, they will have to seek investment opportunities outside the country, if permitted, or in areas other than sources of finance for SMEs. See *Banking and Debt Markets* for further recommendations.

4. Rationalize pension payments. Understatement of salaries for purposes of pension contributions is almost universal among employers and receives tacit approval from authorities who do not seek to enforce accurate reporting and payment. Pension payments need to be rationalized at a level that BiH SMEs can afford to pay, with the law adjusted accordingly. This “approved” non-compliance creates disrespect for the rule of law and disrespect for the government.

5. Overhaul the pension system. Payments are not the biggest problem in pensions – the entire system needs long-term, systematic technical assistance through strong project support and supervision.

## V. Business Development Services and Human Resource Development for SMEs

The single most important resource for SME development is not laws, technology or even finance – although these are essential – it is the human beings who run the businesses. The quality of human resource development greatly determines the ability of an SME to meet its business goals and of a country to attain its desired level of economic development. Both require investment in these resources: at the outset through the formal educational system, and thereafter through specialized programs and services.

In the profitability equation for SME success, investment is a cost. This includes “sunk costs” – foundational investments in the basic quality of the resources – and recurring costs of maintaining competitiveness through ongoing training and business enhancement strategies. Sunk costs are normally paid for by a combination of state funding (through tax revenues) for basic education through the formal educational system, or private funding by students who attend private educational institutions. Occasionally, a business or individual will add to the basic investment through a graduate degree or extensive advanced training. In addition, sunk costs include expenses incurred in obtaining the educational pre-requisites for moving into a new line of business, or the separate one-time investment costs of starting a business. Recurring costs include ongoing internal and external training to upgrade skills and keep up with changing technologies and business environments. These are often provided through short-term education and consultancy services, including in-house training programs, schools and other institutions, and private consultants. Other costs include membership in associations and other organizations that provide business services, such as advocacy, networking, linkages and occasional training programs. These associations reduce the high individual costs of obtaining the same services alone by pooling resources of membership fees.

For businesses in a changing environment, one of the greatest risks is ignorance. Business and human resource development services enable SMEs to avoid this risk by regularly upgrading the information, knowledge and skills needed to keep up with their competitors and the world around them. Another risk comes through using untried, unreliable services, in which the cost of the services purchased is below the price paid, leaving the business in need of further investment in the same area. This is a market risk – historically described by the term *caveat emptor* or “buyer beware” – which can be mitigated through programs that certify the service suppliers for quality.

Revenue potential increases when an SME has the education, training, information and knowledge needed to understand the market, control internal costs, and identify new opportunities. In other words, a profitable SME or SME sector depends greatly on its investment in human resources through appropriate service providers, organizational affiliations, and linkages.

In a developed economy, there is normally an interconnected web of companies and support services providing the necessary human resource development programs that allow industries and companies to compete more effectively. In transition countries, such as BiH, SMEs operate with more limited connections to other firms in their business sector, restricting the potential to improve their performance and compete in

the market place. Businesses typically rely more on their political connections<sup>55</sup> to gain market advantages rather than focus on thriving through successful competition on a level playing field. While the emphasis on political connections may help individual businesses become profitable in the short term, the benefits to the overall economy are few. Connections reduce the importance of merit and competitive quality, and result in growth for a few at the expense of development for many.

Of course this is a cyclical process. Reliance on political networks creates patterns of interlocking interest that restrict market entry and give advantage to some firms. While the market then functions badly, the interlocking interests thrive, increasing their power to manipulate the situation. The opposite is also the case. Where enterprises thrive in competition with each other the support networks of specialist services and relationships develop to further enhance this competitiveness.

A vibrant, competitive SME sector in BiH can only begin to develop if these barriers to competitiveness, political and otherwise, are removed. Since the barriers to the SME sector are so enormous, a cluster development approach is often viewed as the most effective way for businesses to build collaborative relationships that bring the necessary pressure on government to change. Additionally, the collaborative relationships formed by businesses within a cluster create synergies that encourage increased business activity, thus enabling new business support services to enter the market to service these cluster members.

With input from the private sector, donors can design interventions in business support service markets that tackle market failures and create faster development of the service web. This would allow SMEs to focus on improving their performance in the marketplace as a better option for business growth and profitability, increasing their regional and international competitiveness at the same time.

There are two types of interventions:

- Supply-side. When there is a demand for services that have not been supplied by the market, donors can intervene to meet SME needs. For example, projects can provide:
  - o Training for business development service providers
  - o Quality assurance and accreditation programs
  - o Introduction of new methodologies and technologies to professionals who work with SMEs
  - o Technical assistance or funding to business associations to develop a suitable service mix to build and sustain membership
- Demand-side. Sometimes services exist, but at a cost structure that is not in line with the current market realities of a developing or transition country. Donors can help connect supply and demand in the short-term while the market adjusts costs and pricing in a more appropriate fashion. For example, projects can provide:
  - o Assistance to management consultancy service providers so that they can lower their prices to a level that SMEs can afford to pay

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<sup>55</sup> “Political connections” is not limited to official governmental authorities; it can also refer to donors. It is therefore important to design interventions carefully to avoid restricting access or distorting competition based on connections to the projects.

- o Direct grants to SMEs to cover some portion of services at the existing price levels of service providers
- o Sector-focused services that reduce individual costs through pooled resources
- o Awareness raising programs on the benefits of business development services, so that SMEs understand that investment in such services will pay off through improved business performance.

With both types of interventions, the aim is to provide a temporary but sustainable stimulus, enabling the market to function more effectively without further intervention. Such interventions may lend themselves to donor sponsorship because of their temporary nature.

In addition to the above, however, there is a further area for project support of business development services: improvement of public services. Such interventions take two forms:

- Improving services that are primarily provided by the state and which will subsequently be financed by the state. The classic example of this is vocational training of young people entering the labor market for the first time.
- Interventions to further political, social and economic objectives of the state. This might include programs that reduce political and social barriers, focus on exporting, encourage research and development, or support strategic sectors, among other possibilities.

Governments manage such interventions through their own staff, establishing semi-independent state agencies and contracting external agencies. For all types of intervention, there is an emphasis on partnership with the private and community sectors to assist in tailoring interventions to real needs. The dynamics of most interventions require external contracting as principle means of providing temporary and strategic interventions. Quasi-governmental agencies and public sector staff are used for permanent major intervention areas, e.g., vocational training or attraction of inward investment.

## Current Situation in BiH

### *Local*

Donor efforts in BiH initially focused on the local level, providing advice and support for restarting enterprises and agricultural production, integration of returnees and creating new business and jobs to address poverty. Municipalities were a focus for much of the initial activities alongside international and local NGOs and local associations of entrepreneurs. Advisory services, training, grant programs and micro-credit activities have all subsequently been developed through a web of local and regional programs. This initial round of intervention saw the creation of many start-up support agencies. Unfortunately, many of these agencies disappeared as donor funding ended.

Subsequently, a number of pilot projects have focused on economic and social regeneration of local areas. Local development strategies tend to emphasize partnerships between the public, private, and civil society sectors to create consensus



in setting, prioritizing, and implementing local development strategies.<sup>56</sup> Frequently, these economic regeneration projects set up one-stop shops in individual municipalities<sup>57</sup> and local advice agencies for business support. They seek to create a supportive local environment where enterprise can flourish, taking full-advantage of competitive and comparative advantages to create or expand economic activity for greater development and employment.

A wide range of specific small scale, mainly micro-business development projects also exist. These projects focus on particular populations (e.g., youth, women, small-scale agriculture producers). While many different donors fund these projects, SEED provides a central development resource (networking and training) to associations managing such projects. Still, information interchange is insufficient.

### *Regional*

Currently, the EU is financing research to create regional development plans and implement a network of Regional Development Agencies (RDAs), with a focus on SME development. The EU is creating the RDAs from a combination of new organizations and expansion of existing bodies. The EU is also emphasizing a partnership approach to match member municipalities with partners drawn from the private sector and NGO community. The RDAs will administer a grant program (initially only EU funds) to fund local economic and social regeneration projects, including services for SMEs. The RDAs also plan to administer guarantee funds to support SMEs seeking loan finance, although the source of funding has yet to be identified.

The RDAs straddle the entity and canton political structures and rely on participation by municipalities to tie them into the public policy arena. Their long-term future is dependent on the success of this organizational strategy to work with municipalities and their private and community partners. The extent and success of local development strategies and their integration with the regional one is critical to success of the whole strategy. Unless the major technical assistance programs for creating local development strategies are coming to an end, the RDA development initiative may prove to be on shaky foundations. Success will require a combination of local political support and involvement of the private sector as a full partner, both in developing regeneration ideas and as implementers of ensuing plans.

### *State and Entity Levels*

Although donors have assisted national public institutions in creating a more business-friendly environment, there is little assistance for the development of either strategy or actual support services for business at state or entity levels. The main exception is support for the development of the Foreign Investment Promotion Agency (FIPA) by the EU to encourage foreign direct investment in BiH companies. The State government has issued a poverty reduction strategy emphasizing the role of the private sector, but there is no implementation strategy for achieving these goals.

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<sup>56</sup> EU, USAID and other donors have supported the creation of local development strategies by small groups of municipalities in partnership with the private and community sectors.

<sup>57</sup> The EU has assisted 12 individual and small groups of municipalities to create one-stop shops and provided support programs in Banja Luka and Brčko. SIDA has sponsored two municipal projects and is working on four more with GTZ. USAID has targeted more than 60 municipalities, while DFID is supporting similar developments in two areas.

The OSCE, World Bank and EU have made long-term commitments to supporting educational reform. The EU has concentrated on updating the vocational training system and linking the system to active labor market interventions. This has achieved major changes in curriculum for several important trades and increased understanding of active labor market interventions within local offices of the National Employment Agency (PAS). Other donors have worked with individual PAS offices at the municipal level, creating further pilot areas that demonstrate successful approaches.

The Bulldozer Committee has helped to create a forum where business concerns over regulatory barriers can be addressed. The move towards creating regional committees will help link the process into regional development strategies. (Bulldozer is being incorporated in Phase III into the Regional Development Agencies to ensure local participation in driving the process of change forward.) USAID is also planning to set up a national competitiveness council under an upcoming competitiveness project. The council will consist of high level business leaders who work with government to set national strategy on improving the competitiveness of BiH.

#### *Individual Enterprise Level*

Several donors have recently begun identifying and supporting growth companies. Donors are also concerned about assistance in helping privatized companies adjust to market conditions. A number of projects providing professional management consultancy services for these businesses are being implemented by the EU, DfID, USAID and SEED. Together they have provided over 750 individual companies with extensive free or highly subsidized<sup>58</sup> management consultancy.

These efforts have helped generate a base of local consultancy skills that could be used to provide ongoing commercial support services for established SMEs. Unfortunately, there are a number of barriers to this market development, not the least of which is that the pay is much better working for donor projects than launching commercial services to provide market-priced services for individual enterprises.

More recently, USAID, DfID and GTZ have initiated work with selected groups of companies, creating linkages and facilitating development of industrial clusters designed to facilitate joint collaboration between businesses to improve profitability and expand into new markets.

#### *Cluster Development*

Cluster development is a new concept to BiH. GTZ and USAID have only recently introduced this approach to select industries. Since these efforts are so new, members of the business community and government remain largely unaware of the cluster approach. GTZ and USAID are focusing on international market demand, moving toward more sophisticated and higher value-added products, encouraging innovation, and collaborating with businesses while forging strategic partnerships between policymakers, firms, educational institutions, advocacy groups, and business service providers.

Developing clusters will bring together key companies and relevant support institutions (academic and commercial R&D centers, specialist trainers) into a

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<sup>58</sup> SEED is the only provider to charge SMEs a significant sum. SEED aimed to cover the local consultancy costs, providing international consultancy for free. EUPER was initially free but then introduced some charges towards local consultancy costs

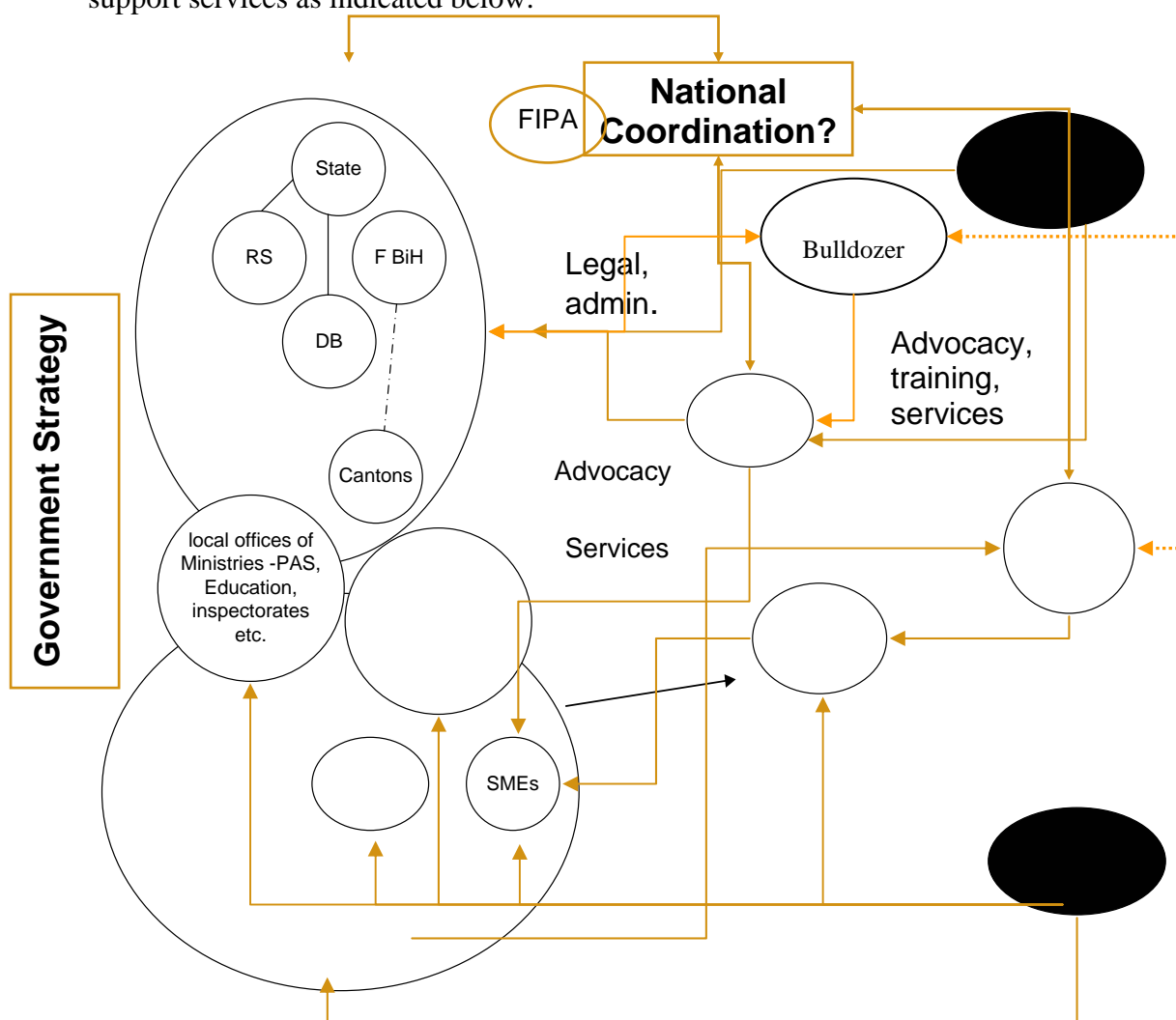
collaborative arrangement. This is separate from business associations (focused on a sector) or RDAs (focused on a geographic area). Clusters thus capture another perspective on business needs that can inform and urge on the wider business environment reform process led by government.

### *Business Associations*

Several international donors have provided support for association development in BiH, including USAID, SEED, the EU, and GTZ. The different initiatives focus on improving the associations' advocacy skills. These skills allow associations to promote member interests with national level policymaking institutions and to develop services that make it worthwhile for members to pay their dues. However, these organizations remain fairly weak at this time.

### *The Resulting Web of Interventions*

Collectively, donor funding has helped to create a complex system of business support services as indicated below:



### *Commonalities of the system*

This complex system underscores the Rubik's cube qualities of providing appropriate interventions to address gaps. However, several key interlocking themes can be identified that affect the subsequent discussion of gaps.

First, public-private partnership is a central requirement for good public policy development and implementation in the field of business development services. This of course applies to donor programs as much as initiatives developed with national and local levels of government. However, encouraging SME participation in partnerships is being tackled separately at local and national levels with little apparent interaction between the two.

Second, pilot activities are developing mostly on a local level, including projects with local branches of national organizations (vocational schools, PAS, and state inspectors) and small groups of municipalities. Although these are good building blocks, they are mainly for local economic development strategies. Even though RDAs build on these activities by creating coordinating partnerships and organizations, national co-ordination of the BDS activities is desperately needed. Apart from the vocational education and training initiatives, there is no clear path for developing state and entity level SME development strategies or focused programs. Currently, FIPA is the only example of a national level support service. Business development service programs must resolve this gap over the next few years.

Third, donor programs generally provide services to SMEs free of charge, even though many local staff are now trained to deliver these services at local market prices. Unfortunately, sustainability in many areas will only be achieved if sufficient commercial income can be generated to pay ongoing fees to these local professionals. Donor projects need to introduce fees for their BDS work set at a local commercial level if a sustainable market is to be created.

## A. Supporting Start-up Businesses

Most people starting a business cannot afford to pay for support services, especially in developing and transition countries. They hope that their basic level of knowledge and their initial resources will be enough. Often it is not. There is a high risk of failure in start-up businesses everywhere, which could be mitigated with start-up support. Because SMEs cannot afford the services they need, there is inadequate commercial demand to create a service industry that could support them. This leads to a self-defeating cycle: SMEs need assistance that they cannot afford; service providers do not develop because they cannot survive financially with low-paying or non-paying clients; then SMEs who decide to seek assistance find that there is none, and stop seeking, further undermining demand.

Governments around the world have decided to enter the market to close this gap. They work with private sector service providers or through government agencies to make information and training available to businesses that cannot afford it. In the US and EU, governments promote a wide range of support services for start-up businesses. They promote possibilities of self employment as well as SME opportunities in areas of economic concern, such as depressed neighborhoods, areas with high unemployment, or changing industries with high downsizing rates. They also target growth in new markets, providing, for example, free or low-cost seminars for SMEs interested in exporting.

The goal of these services is to lower the costs of obtaining the knowledge and skills necessary for success. Services may be provided directly by government, or indirectly by subsidized private sector firms and consultants. Some programs involve a system that enables businesses to choose services from competing firms, rather than simply hiring one firm to provide the services.<sup>59</sup> In some cases, programs are joint subsidies that develop both the new businesses and the service providers, so that the consultants can eventually become self-supporting by providing additional services to successful companies as they reach new stages of growth.

The range of services include, among others:

- Information on the legal and regulatory environment tailored to the type of business being considered (for example, registration, licenses, or labor law)
- Information and guidance on access to finance
- Grants or other low-cost finance for disadvantaged groups
- Guidance on marketing and information sources available for their planned business
- Counseling on the decision when and how to form the business
- Referral to specific skill training that might be necessary before a business can be launched
- Financing

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<sup>59</sup> For example, Slovenia has introduced a national voucher counseling program that enables beneficiaries to purchase services from a range of providers. In Poland, public funding (including several donor funds) is awarded every two years to providers based on past performance and competitive proposals for delivering the next phase of services.

- Support to develop basic business management skills through short training workshops (finance, marketing, accounting, administration, etc.)

Services are normally delivered in the form of:

- Small group workshops for awareness raising and basic skill training
- One to one counseling and needs diagnostics
- Basic information documents

In recent years, there has been an increase in the development of business “incubators” as well. These programs assist groups of new entrepreneurs, generally with a sectoral focus (industrial, communication technology, or design, for example) or specialized demographic emphasis (such as university graduates or others believed to have higher potential for new business growth). Incubators often combine physical resources, such as low-priced office space with information resources, including internet access and business counselors, to create a cluster of resources necessary for start-up success.

Another approach combines simplification of start-up procedures with business information for new businesses. Governments reduce administrative barriers to entry by creating one-stop centers for registration and licensing. In addition, these one-stop shops may provide practical technical and market information.

It is important to keep in mind two different perspectives. From an SME viewpoint, support services reduce the costs of start-up, allowing them to free some of their assets to pursue revenue opportunities; lower overall risks through better understanding of their business; and lower the risk of failure due to ignorance. For governments, such services are justified in order to reduce unemployment, increase the tax base, and improve economic development through reasonable investment of public funds. SMEs do not care about government concerns: they care only whether the services provided help them achieve their goals at an affordable cost.

## Current Situation BiH

The SME sector of Bosnia and Herzegovina used to be tightly linked to large state-owned enterprises. When these SOEs collapsed after the war, the SME sector collapsed with them. The old regime developed a system of dependency, in which SMEs were used to having everything organized for them by the state. With the economy in disarray and the state unable to provide assistance, many began to develop their businesses in order to survive. Although many still hold on to a hope that large enterprises will return to employ the population, many are beginning to understand that the future of economic development and prosperity lies with successful development of SMEs.

Participants at the workshop debated the extent to which there is sufficient entrepreneurial culture in BiH. On one side were implementers who had seen low levels of initiative and responsiveness to various opportunities requiring initiative. On the other side were those who noted that informal business (gray market) is essentially entrepreneurship, and it employs at least 40% of Bosnians. Others cited lending statistics for the proposition that MCOs and bank projects had no trouble finding borrowers for new investments. (USAID’s six MCO partners under the Business

Finance Project alone made over 5,000 loans to SMEs during the period August 2002 through August 2003.)

This enlightening exchange highlighted the complexities of a society in transition. While it is true that authoritarian regimes produce dependence and stifle initiative, the younger generation has not experienced the same level of indoctrination. Variations in implementer experience appear to be based in part on the groups they are working with, and may indicate as well that some of the projects are not offering services that their stakeholders want. The question merits further examination, but clearly there are large numbers of entrepreneurs in BiH.

To address the gap in affordable services for a relatively poor population, donors have financed a wide range of free start-up business services, but many service providers have closed once funding ceased. As noted in the introduction, this is normal, especially where the base income is quite low. Even in North America and Northern Europe, governments subsidize start-up services. In BiH, the various governments are still highly dependent on loans and grants from the international community, so that donors currently provide the needed support. It is not clear how long it will be before local governments can provide such support, or what type they can afford to provide.

To date, donors have delivered most start-up assistance to disadvantaged groups (refugees, returnees, demobilized soldiers, war widows, disabled, young people, unemployed, and local area focused poverty reduction programs) through a complex and changing network of programs and providers. This has included major international programs (e.g., World Bank Emergency De-mobilization Reintegration Project (\$20m 1996-99), EU Returnees programs (€3m current program), plus many direct donor projects and indirect delivery through NGOs (using a complex web of grant aid sources).

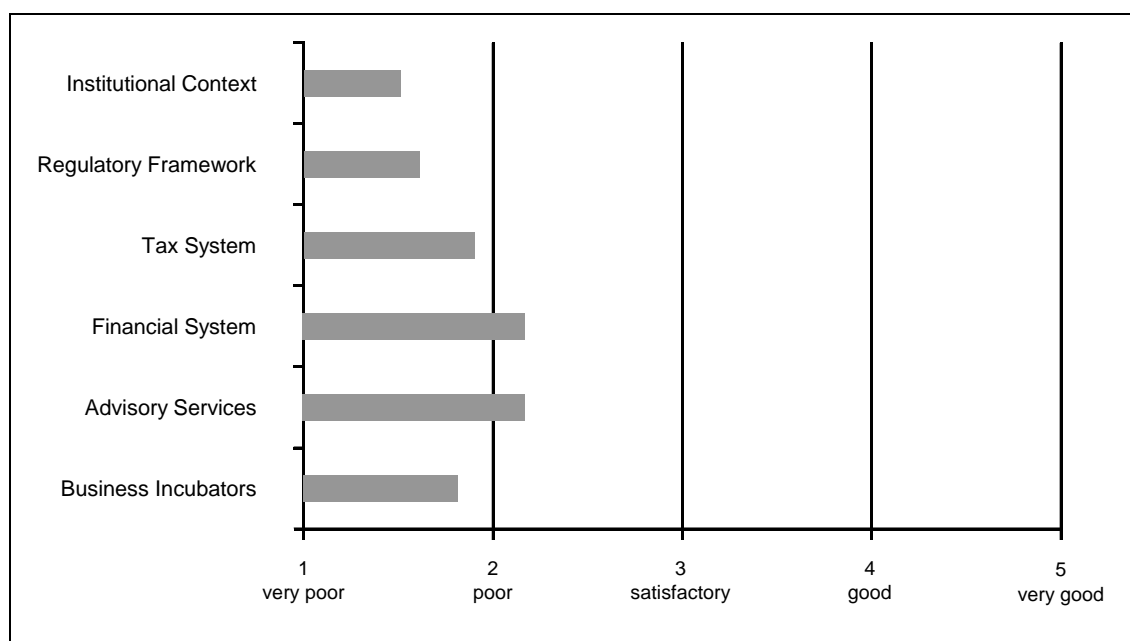
Some projects have tried to institutionalize services by establishing associations of their target group members. Theoretically, these associations will learn to provide services to their members as a benefit of membership, while simultaneously learning the skills they need to provide such services. Not all such associations represent a response to market demand for either the association or the services, but are more characteristic of social development programs. Experience elsewhere suggests that sustainability will be a serious issue for many when donor assistance runs out.

The majority of business development services are provided in the form of short training courses on basic skills, with individual advice and counseling sometimes provided directly or through a third local organization (association or municipality). The training and advisory services sometimes interact with specific micro credit funds. Some projects provide direct grant aid to their target group to cover start-up costs, acquisition of capital equipment, and working capital needs. Agriculture-oriented projects train in basic technical skills (e.g., harvesting wild herbs) and often supply business advice and small grants, usually for micro businesses. In some cases, services include promoting a new business idea to potential entrepreneurs, which is made in collaboration with an established company seeking local suppliers or home workers.

Recently, GTZ and CIDA have focused some support on establishing incubators. Several proposals are currently being considered for funding. These include managed workspace proposals as well as more traditional incubators.<sup>60</sup> Public awareness and understanding of incubators is low.

Currently, the OECD focus group research<sup>61</sup> is the only evaluation of these services from the client viewpoint. This research used a range of focus groups to score effectiveness of services available, as well as other factors in the environment. The SMEs participating assessed all six dimensions of the framework and the environment supporting SME growth and development as “poor”. See the following chart.

**Average Ratings of the Six Dimensions of Good Practice  
by SME Owners and Managers**



In addition to specialist start-up advice, some recent donor-supported programs are enabling services in specific local areas to all business start-ups in conjunction with local municipalities<sup>62</sup>. Some local Employment Bureau offices<sup>63</sup> are also providing start-up advice as one of their services to assist unemployed people. These local

<sup>60</sup> Incubators are either based in a building or offered as a “virtual” service. In either case, a range of subsidized services is provided to targeted start-ups to facilitate rapid development and growth of new businesses. Private sector incubators exist, especially in the information technology area, where private investment is recouped by taking shares in the companies assisted. Managed workspace is a property subdivided into small units offered at a commercial rent, sometimes with administrative and support services included.

<sup>61</sup> OECD Enterprise Policy Performance Assessment – September 2003.

<sup>62</sup> The Swiss have assisted two municipalities to establish one-stop shops for registration and licensing and are currently rolling this out to four more. This is intended to form the base for a manual on reform of local services. One-stop shops will also be a focus for providing basic business information. Sarajevo RDA is working with three municipalities to develop local business service centers financed entirely by local public money.

<sup>63</sup> Both EU VET program and DFID PPERP have helped specific offices of PES establish services for start-ups.



service developments have been achieved with a combination of donor funds and technical assistance and by the local funds of the public authorities<sup>64</sup>.

Aside from incubators, there are other assistance efforts geared toward lowering costs and difficulties of start a business. USAID is pursuing a major program for the creation of one-stop shops, in which redundant government services are reduced and compliance regulation provided to investors. These units allow SMEs to take care of registrations, applications and other business filings at one office through simplified and consolidated forms, instead of wasting time at numerous offices filling out redundant, time consuming paperwork. This reduces business costs while establishing a new and better relationship between government and business. The USAID program will expand the concept to most significant municipalities and integrate better with Cantons and Entities. In April 2004, USAID and SIDA will launch a one-stop-shop project in 40 additional municipalities throughout BiH.

Municipal governments are showing increased interest in creating and operating effective one-stop-shops. Many of the current non-project municipalities are planning for a one-stop-shop of their own – either by way of lobbying for international donor assistance, by securing loans from private banks, or by making capital plans from their own budgets for 2005.

## Gaps

There is a relationship between several of the gaps that leads to priorities. On the government level, the lack of a comprehensive strategy means that it is difficult to leverage donor assistance or national initiatives for the greatest impact. Donors can assist greatly in this area, but also need to make some strategy adjustments of their own. This includes expanding the reach of services beyond disadvantaged groups and better dissemination of expertise on implementation of such services. It is also true that there is a poor understanding of the importance of SMEs to the economy, which may be one reason that the strategy is undeveloped. By working with government to address strategy, expand outreach and provide information, donors will help to improve understanding through interaction. On a more practical side, Roundtable participants also felt there was a great need for increase incubator or other shared, lower cost workspace. The gaps below follow these priorities.

*Lack of Strategy.* Today, there is no comprehensive strategy at any government level for SME growth and development, so that reforms, projects and interventions are insufficiently coordinated, prioritized or targeted for maximum impact. There is also no comprehensive baseline data on the number or sizes of SMEs, where they are located, their industry profile, or their perceived needs for assistance, which should serve as a basis for strategic assistance. Studies on competitiveness have filled some of these gaps, but not completely. Without such information or strategies, it is difficult to coordinate and leverage resources, define resource needs, or otherwise implement donor or government projects for maximum impact.

*Insufficient coverage of service programs.* Roundtable participants agreed that providing items like legal support, accounting support and IT support were being

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<sup>64</sup> Instances of a few municipalities establishing such services without accessing donor funds or technical assistance have been reported but not verified.

done now to assist start-up entrepreneurs overcome their fears and help reinforce their courage. This support to date has been provided by the donors to disadvantaged groups, such as returnees and veterans. They felt that enough time has passed and these basic services should be offered to all entrepreneurs rather than qualifying recipients on the state of their disadvantage, but there are currently no significant plans for providing services beyond the disadvantaged targets.

*Lack of information on local lessons learned.* All conceivable start-up services are already being provided in BiH through the numerous donor programs. Many of these are producing valuable lessons on what is or is not effective, but there is no convenient system of sharing this information to enable others to avoid identified pitfalls or replicate successes. BiH needs a central database of all business start-up projects and a way for businesses to exchange their experiences.

*Lack of shared workspace:* Incubator projects are only beginning, so that the supply of planned and purpose-designed shared enterprise accommodation is low. Enterprise zones, shared service centers, industrial parks and possibly business incubators all open up the possibility of linking new start-up services with arrangements for technology transfer. Such set-ups can enhance the success of high potential start-ups, and promote greater levels of innovation and technological support, including new product development, design, marketing and licensing.

*Poorly organized municipal services.* Municipalities are becoming key partners for much SME development. Current one-stop shops are improving the quality of customer services for citizens, but less than a third of municipalities are targeted for assistance in re-engineering and improving their service offerings through this approach. Much of this assistance is focused on citizen awareness, not business functions, so that it is not achieving full potential for an SME perspective. With process management software being developed by implementers, there is great potential for expanding the impact of the current projects to improve business services and by providing software with training to more municipalities. One-stop shops have the potential to become the primary access point for information on business support services.

*Poor understanding of SMEs and entrepreneurship.* A number of workshop participants and interviewees noted the poor understanding in BiH of the importance of SMEs. In the past, SMEs were directly connected to SOEs, and any initiatives not connected to the state-sponsored activity were held in suspicion. Today, many policymakers, government officials and average citizens still do not understand the importance of entrepreneurship and SMEs for economic development. This misunderstanding undermines efforts to introduce customer-oriented municipal services (such as one-stop shops or improved processes) and discourages some from pursuing entrepreneurial activity. There is an ongoing need to ensure a positive image for entrepreneurs, encourage people to take the risk of forming a business and provide access to the information needed for a new venture to be legal, well financed and effective.

## Recommendations

1. Develop state-level SME strategy and policies. There are at least six ministries involved in SME development in the state and entity level governments, but no

national strategy, nor baseline information to support such a strategy. Under these circumstances, the potential for conflict, redundancy, and inefficiency is very high. Assistance is needed to create a system for planning and coordination, which should include the following:

- a. *Baseline information.* Strategies should be based on a clear understanding of the existing situation. A baseline study is needed to profile the SME sector more comprehensively, starting with a proper definition of SMEs, and including basic information on the numbers in each commercial sector and geographic region, employment statistics, and general market information on priority sectors.
- b. *Strategy.* Using the baseline data, assemble appropriate policy makers and private sector representatives to set priorities and strategies for improving service delivery to SMEs. The strategy should include a system for feedback from the private sector to ensure that the proclaimed goals are actually meeting SME needs.
- c. *Strategy Unit.* Unless there is clear responsibility for strategy implementation, there is no responsibility. The current situation of uncoordinated work among six separate entities needs to be reformed. One possibility is to create a single state-level independent agency responsible for consolidating and developing SME policies into a national strategy. This SME Development Agency (SMEDA) could then coordinate activities of RDAs, donors, local communities, business associations, and others to ensure better policy implementation. It could also promote joint strategy work among state and entity stakeholders to ensure harmonized efforts. The agency personnel should be trained in policy development, strategic planning, and project management.

2. . Provide basic start-up services to all entrepreneurs. In addition to supporting the disadvantaged via existing and planned programs, the state and the donors should support the initiatives of the RDAs in developing support for SME at the community level. To avoid problems or accusations of preferential treatment, services should be provided on a first come, first served bases – for a fee – through one-stop shops. Scholarships can be made available, based on published standards, for entrepreneurs with good ideas who cannot afford the fees. The funding for the scholarships could even be provided by “graduates” of the previous scholarship programs.

3. Create a system for replication and exchange of experience. The SMEDA, or existing agencies and ministries responsible for SME development, can collect and make available information and lessons learned from implementers and project personnel as a starting point. It would also be useful to survey on lessons learned in start-up services from the RDAs among the existing service providers, collate and analyze the data and publish these experiences. A data base of this information should be established and updated annually as new lessons learned surveys are conducted and projects produce more information.

4. Workspace: The SMEDA should develop a means of encouraging and supporting the provision of workspace for business incubators and shared workspace in enterprise zones, shared service centers, industrial parks, office parks. These initiatives open up the possibility linking new start-up businesses with service providers, with viable businesses precipitating learning, training and technology transfer. This can also be useful in cluster approaches, bringing together complimentary services for greater learning, integration and profitability.

5. Expand use of process re-engineering tools to more municipalities. Project assistance is planned for approximately 50 municipalities to develop improved, simplified services through one-stop shops and other re-engineering tools. This includes software development for process management. While providing extensive assistance to selected municipalities under the planned roll-out, implementers should find ways of exposing all surrounding municipalities (and their residents – to increase demand for reform) to the changes, and providing local officials with information and software. Officials adopting changes should be encouraged to promote and share the experiences in the surrounding region, even acting with local re-engineering consultants to provide input and assistance. Depending on the ability of non-targeted municipalities to implement programs on their own, additional project assistance may be advisable.

6. Promote better understanding of SMEs and Entrepreneurship. Public information campaigns are needed to overcome biases against SME and suspicion of entrepreneurs. The campaign should promote a positive understanding of their role and importance, and even encourage the public to buy goods and services from SMEs. The campaign could include basic information on how to start a business as well, with information on how to find out more. Such a campaign would be ideally suited to the proposed SME Development Agency. It should also address reforms of curriculum and information taught in schools and universities, while working with RDAs and business associations to ensure wide implementation and dissemination.

## B. Education, Training and Consultancies

Education and training are part of a lifelong learning process needed to address the ever-changing challenges of business. For SMEs, such learning has a direct impact on the costs, risks and revenues that SMEs must balance for their success. Such learning starts with formal education, including vocational schools. Other programs then build on this education by providing continuing education for new and improved skills. Lifelong learning thus requires a variety of providers offering courses, seminars, workshops or even one-on-one assistance from consultants. The complex of services offering education and training is a fundamental element in long-term national economic development and competitiveness.

In *The Illusive Quest for Growth*, economist William Easterly notes that simply investing in education does not result in economic development. Numerous educational programs have failed to produce any significant impact on local development. In fact, some programs merely help to train young people to get jobs in other countries. Education and training must be designed to enable the recipients to meet the challenges of their markets. In other words, competitiveness is not based on having the best education (whatever that may be), but on having relevant education.

The bulk of cost of formal education in most countries is covered by the state through tax revenues. The entire country shares the investment, so that it is not overly burdensome on any one group or sector. Upon graduation – whether from high school or post-graduate institutions – those entering the work force must begin applying their education to the productive endeavors that employ them. All jobs require some on-the-job training, which is a cost absorbed by the employer. If the basic educational level is high, this additional training is much less expensive for employers, reducing their costs and making them more competitive. If not, business must invest more heavily in additional training or re-education, or else focus on lower paying work that does not require much education. Either way, the economy suffers when the formal system produces does not adequately prepare the labor force for the labor market.

Continuing education is a crucial part of keeping up with the rapidly changing business environment. New approaches, new markets, new strategies, new trade relationships and a host of other changes mean that SMEs must regularly update their knowledge and skills to avoid the risk of obsolescence. To do this, they will use courses offered by schools, business associations, or even equipment suppliers, as well as consultants who can help them analyze and meet their business needs. Worthwhile training should generate increased revenues to cover the costs incurred. Lack of training is far more expensive: the cost of ignorance can be the end of the business.

SMEs do not always have sufficient scale to provide entry-level on-the-job training. This is where trade schools or trade programs in existing schools reduce the firm-level cost of training by passing it either to the student through tuition or to the community, through taxes. These institutions provide invaluable assistance to the business community.

Increasingly, competitive advantage and entrepreneurial success depend on a flexible workforce. A country must offer opportunities for individuals to change or enhance their careers by learning new skills. Traditional systems of education often create a dissatisfaction gap: young people are channeled into career paths based on marks and choices achieved when they are 16, well before they know what they want to do or can achieve with their skills and talents. This can be addressed through adult education programs that allow them to change from a dissatisfying, unproductive job track into an area that matches their strengths. These programs have grown steadily in developed countries over the past few decades, and are desperately needed in transition countries.

## Current Situation BiH

Pre-war BiH was a major industrial manufacturer. The education system produced people with suitable skills for the specific jobs provided by the state. A developed Research and Development (R&D) base linked to the companies enabled ongoing modernization of manufacturing and introduction of new production at a suitable pace for Yugoslav conditions, at least in applied sciences such as engineering.

On the other hand, the Yugoslav education system was also designed to encourage a high degree of compliance and subservience. Pedagogical techniques were based in great part on 19<sup>th</sup> century continental models of information impartation, in which students at all levels – from 1<sup>st</sup> grade to university – passively receive lectured information then repeat it with minimal analysis at exam time. While this approach can impart a great deal of information, it does little to promote diagnostic, deductive or analytical reasoning. In fact, some areas of education were undermined (such as social sciences) to discourage questioning of the government.

The collapse of the command economy, along with the war, has fundamentally changed the fit between the educational system and the needs of the country. Education oriented to the needs of SOEs does not enable workers and managers to understand or apply the flexible working practices used in developed economies. Management of competitive companies in a global market is a completely different discipline than the management in a command economy. As SOEs have dissolved, thousands of adults have become unemployed, with education and skills for businesses and processes that are no longer needed or in use. Many of the best educated and most highly skilled citizens who could lead changes have left the country for better work and safer conditions elsewhere. In short, dramatic changes are needed at all levels of education and training to refit the country from the past to the present. Otherwise, BiH will have to compete for low-paying jobs with other under-educated nations, face ongoing high unemployment, or both.

Faced with this very difficult post-war environment, donors have pursued a number of different approaches to improving human resource development, including the following

### *Vocational Training*

EU has adopted a major long-term program in the reform of the vocational education system. They have worked at the state and entity levels to gradually build consensus for major reform. A number of pilot projects help individual schools and groups of schools modernize the curriculum for a number of major occupations. These projects

have merged a large number of differentiated vocational skill areas into a small number of broader skill sets. Assistance has been given to pilot schools to develop links with the local business community and the employment service (PAS) to help identify future employment opportunities and develop the skills to adjust their curriculum accordingly.

EU VET also developed training of trainer (TOT) programs to help vocational school teachers develop adult training skills. The next EU project will have a much higher emphasis on adult training, especially with vocational schools providing part-time courses for adults outside school hours. This would enable more effective use of expensive equipment, bringing retraining more within the reach of SMEs in terms of both cost and after-hours availability. Unfortunately, a number of administrative difficulties over the management of vocational schools budgets have restricted their ability to provide adult education outside the core school teaching hours. Hopefully, these administrative barriers can be removed by the entities and cantons in the near future.

The Government of Norway is sponsoring entrepreneurship training in a number of vocational education schools and the Open Society Foundation has sponsored a pilot entrepreneurship training program in secondary schools. These projects have created and introduced new models for introducing entrepreneurial thinking and business awareness into the next generation of employees.

Swiss Development Corporation sponsored the development and equipment of three training workshops with PAS covering IT, Metal Work and Construction skills. This created a major re-training resource. However, these centers have been struggling to survive beyond the funding period because of the difficulty of charging sufficient fees to cover costs. Some private investment has created successful training facilities, for example Sirius created a CIT training center, which appears to be commercially successful.

A number of donors<sup>65</sup> launched programs to improve operation of local employment offices, assisting them to develop active labor market policies in addition to their social assistance role. These focused on linking SME job vacancies with suitable unemployed people and developing training programs to help the unemployed acquire marketable skills.

In addition, a number of donor projects have sponsored sector specific workshops with associations focused on providing information on new related technology. Mainly geared towards managers, these workshops have helped companies bridge the knowledge gap between BiH and developed markets.

### *Management Training*

All enterprises face growing competition within the global economy. Though BiH is a transition market, global competition still affects the quality and price of imports. As SMEs export their goods, they need to have competitive prices and quality. This requires constant assessments and improvements. Modern management education teaches the skills and methodologies that underpin the search for competitive

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<sup>65</sup> World Bank (Social adjustment & Technical adjustment credits) GTZ, SIDA, DFID, EU VET, EU QIF, Open Society Foundation

advantage. According to interviewees and research by SEED and OECD, local managers are not currently equipped to understand modern management practices and therefore require practical skill training.

Donors have also created a number of development strategies to address management training:

- Many BDS projects have developed one-off training programs for their target groups.
- USAID sponsored curriculum development in university accounting departments and the training of the first 1000 students and 800 practicing accountants and bookkeepers.
- The Soros Foundation helped the Economics Faculty at the University of Sarajevo to create the Center for Management and Information Technologies (MIT) Center. This currently specializes in short programs that serve the immediate needs of the executive level enterprise management in BiH.
- SEED is working on both the supply and demand sides of SME training and education. Working with Business Membership Organizations, municipalities, large company supply chains, and others has helped SEED to identify and connect SMEs with the training they need. On the supply side, SEED worked to develop a training partnership with local educational and consulting companies. This resulted in the development of a network of local organizations in four countries with 26 trained local providers. The training taught TOT methodology and interactive techniques tailored to entrepreneurs, and also technical training courses developed by SEED. SEED gave eight training products to participating educational institutions and now plans to support the marketing of training courses and the development of new products as needed.

In addition other organizations and programs have provided local area one-off training provision in management for smaller enterprises.

Further programs have been developed to create graduate and post graduate development of management skills for the next generation of managers. The EU Tempus program has sponsored a collaborative arrangement between University of Sarajevo and EU business schools to develop an MBA program launched in 2003 for three years.

Recently, USAID funded a four-year project to bring high level graduate business education to BiH through the founding of a new Balkan region business school in Sarajevo. The University of Delaware (UD) will begin offering its Masters in Business Administration (MBA) degree the Fall of 2004 in cooperation with the University of Sarajevo (UNSA) Faculty of Economics. A separate legal organization will be established to deliver the MBA program. The twenty-four month MBA will be presented in Sarajevo and team taught by faculty from UD and BiH. In addition to a high quality business education, the program also provides for extensive mentoring between the faculty and staff of the new institution with their counterparts at UD. Hopefully when USAID participation ends, the new institution will continue to offer high-quality graduate-level education to participants drawn from BiH and abroad.



Apart from this, several programs have trained local consultants but no formal accreditation systems exist and evaluations indicate variable quality in the resulting supply. OECD research with SME focus groups indicated that SMEs find service delivery poor, with an academic emphasis instead of the practical skills and know-how desired.

### *Consultancies*

As SMEs grow, they need access to a wide range of technical and strategic management services tailored to their individual needs. These services are normally delivered by management consultancy practices, accountancy firms, marketing specialists, HRD specialists, ICT consultants, technical sector consultancies, and training organizations, among others. In addition, public sector agencies provide a range of services to established SMEs, such as guidance in accessing public funds or organizing trade missions, for example. Business associations are normally involved in delivering advice services for new entrants, such as exporting, facilitating partnership development and, for sector organizations, providing or recommending technical experts to advise on production, quality control, and other practical business concerns.

In transition economies, government and donors are active in helping to develop both the supply and demand for such services. Often SMEs are unaware of the impact of investing in such services on their profitability. With poor supply, SMEs may miss the expected benefits if they do invest in purchasing external services. In BiH this may be the case: many SMEs report that they receive barely adequate, highly academic advisory services, rather than practical ones<sup>66</sup>.

A sustainable market in support services needs a quality of supply. Despite the great deal of training that has been undertaken, retention rate is low when it comes to local people as business advisors after the program ends. Many trained people are lost to other employment at the end of a particular project, though some movement between projects occurs. Similarly, local consultant companies follow individual donor program lines, with new projects financed by the same donor hiring the same consultancy companies. The result is likely to be a great deal of training for new people in basic skills and difficulty in retaining skilled people.

A major issue is how the provision of services to business supported by donors can help develop the commercial demand for subsequent services. Clearly, well-delivered consultancy projects with individual businesses and groups of business demonstrate the effectiveness of external consultancy on profitability. Temporary free programs can demonstrate the truth of this statement, if the service delivery is timely and tailored to the businesses needs. Feeding back the real costs may help SMEs appreciate the return on investing in future services. Of course, if new free services appear then they will continue to use these in preference to services that charge fees. Equally, if the services are poorly delivered and not tailored to individual needs of businesses then SMEs are likely to conclude that external consultancy is a poor investment. The key issue is how to manage a transition from largely free services driven by donors to market-based commercial services. Collaborative strategies for

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<sup>66</sup> OECD Report.

this must be clearly built into the plans for donor programs if the market development is to be facilitated rather than prevented.

Donors have organized a wide range of interventions to develop the supply of professional advisory services for SMEs. Accountancy training has enabled the development of an accountancy profession better equipped to provide services and advice to clients tailored to the needs of a market economy. A number of training programs for management consultants have been organized by SEED with more specific training programs for local consultancy contractors of such projects as PPERP, EUPER, CGBIP. Additionally, many donor programs such as the USAID Business Consulting have trained their own local staff in delivering advisory skills to businesses. The recent creation of LESP.net as a coordinating association of local consultants may become a vehicle for introducing minimum standards and on-going training of consultants. At present its efforts are limited to the development of an ethical standard.

Many donor programs have also focused on the demand side of the equation. DFID, EU, USAID, GTZ, SIDA and SEED have all created projects providing consultancy support for individual businesses drawn from privatized enterprises, specific trade sectors and growth companies. These have focused on a range of efforts to improve management, marketing and quality control of the individual enterprises plus assistance in raising necessary investments for the resulting business plans. SEED has tried from the start of its operations to charge the full local cost of its services with international consultancy costs met by the organization. Other projects have started by providing free services, sometimes with a growing level of charges towards the local costs of these interventions.

#### *R&D*

The war broke up the pre-war network of university-level R&D activity with direct links to the larger firms. Enterprise needs are rarely linked with current research. The surviving equipment is inadequate for modern research, and university lecturers cannot connect to a wider research base. Growth in the number of universities with the subsequent reallocation of scarce resources has further broken up research and teaching. Equally, much of the teaching being undertaken in universities still follows curriculum and methods established in Yugoslavia. Students routinely complaint that class attendance is unprofitable, with time better spent on mandatory reading of the professor's book. Reform to modernize teaching and curriculum is still needed at this level. BiH needs to develop new graduates with modern skills for industry and linking firms into collaborative R&D arrangements. This will require reform of the system and investment in new structures.

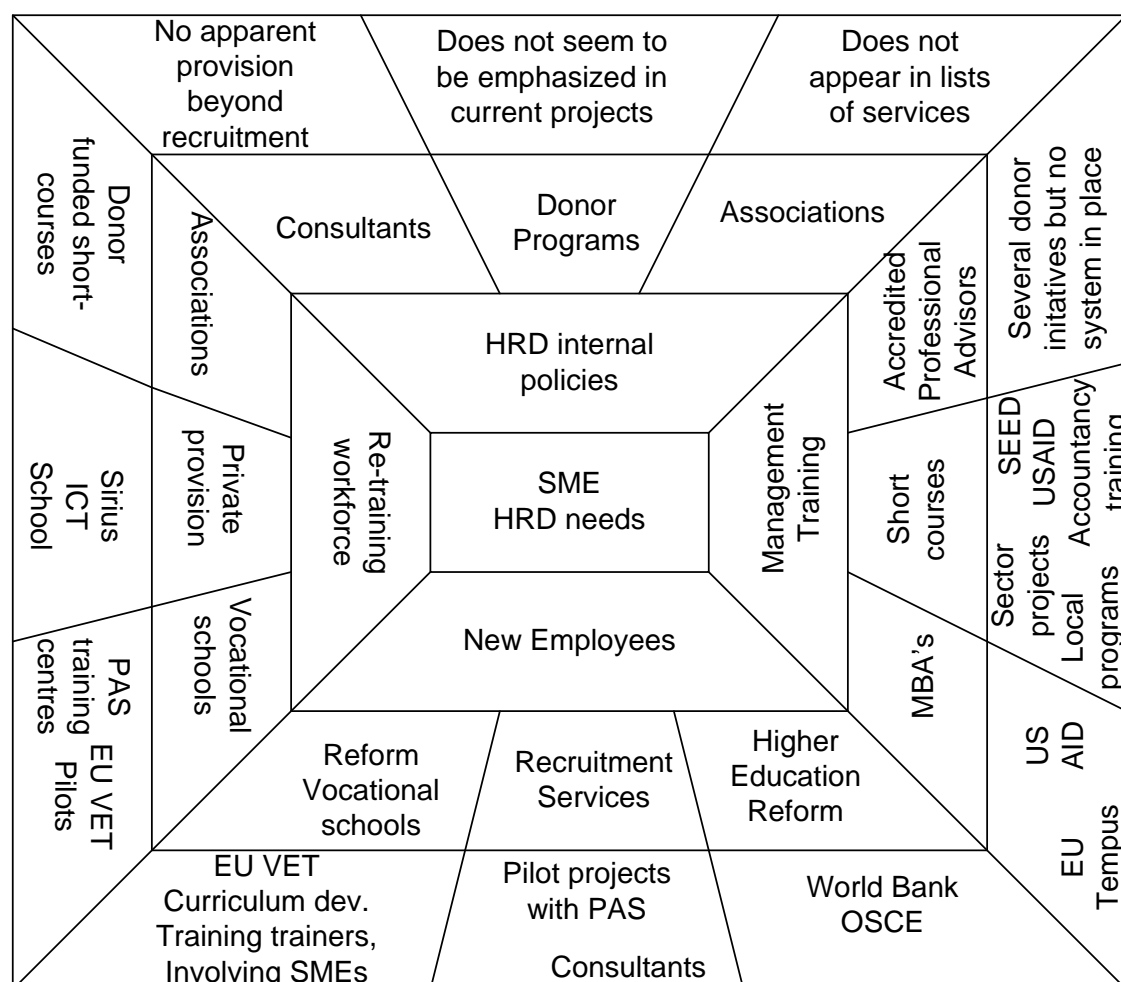
#### *Internal to the Firm*

Developing human resource strategies requires provision of external, high-quality education and training. However, there is also a need to work directly with firms in developing their recruitment and personnel development systems. Currently, this firm-level assistance is lacking. Private HR consultancies exist, but offer first cut recruitment services. Although larger donor programs working with individual SMEs have included improving HRD strategies of the firms, the focus is clearly more on finance and sales than HRD.

Donor projects and several associations organize workshops on employment issues. Yet these have not included any significant focus on HRD as a whole, or the creation of good practice statements and tools.

### *Overall Program of Support*

The following graphic sets out a suggest division of SME HRD needs in BiH and how where major projects are tackling these:



## Gaps

Given the central importance of good human resource development to the competitiveness of modern economies HRD issues are clearly going to be of major importance for BiH to successfully complete the transition to a market economy and become part of the European Union. The brief analysis presented above suggests that the old vocational education and training systems are inadequate for the needs of a modern market economy, even without the major disruptions caused by the war. While significant progress has been made in introducing modern training methodologies, little has yet been done beyond piloting the new models. Most identified gaps arise from the need to share practical experiences and materials, implement successful pilots across the whole country, and build on this base for further activity required to modernize training and HRD.

*Inadequate quality in basic education.* Advanced education builds directly on what is learned in primary and secondary schools. The system in BiH is below standard for eventual European integration. Curriculum has not been updated to instill analytical skills needed by the students for the modern job market. At the higher levels, many courses have generally not been upgraded sufficiently to reflect changed standards or circumstances within specialized fields – such as law, where new laws are not resulting in new law school materials, and vocational schooling, where some schools are still preparing students to work in industries that have disappeared. Educational quality affects SMEs – they must either incur the expense of upgrading useful areas of education that should have been produced through society’s investment in schools, or incur the loss of competitiveness with better educated competitors in the region. The EU is expected to invest in general education, but it is not clear whether there is a focus on eventual needs of students as they enter the SME job market.

*Poor Information Sharing and Dialogue.* With a multitude of relevant projects producing useful training and educational materials, resources are being created that could improve education and training in various fields. However, the information is not getting into the schools. Even worse, few educators have shown much openness to change, with most doing little research or skill development to keep up with changes in their fields or the practical needs of existing businesses. Feeding these valuable resources into the wider education system does not appear to be on the donor agenda.

*Low awareness of training opportunities and benefits.* Many SMEs are not aware of the benefits and availability of new vocational training or consulting. Despite many donor-led improvements in the last few years, there is little awareness of what has been achieved. The pace of change now requires a process of continuing education or life-long learning that needs to be included in the HRD plans of enterprises, but there is little indication that this is taking place. Interviewees and Roundtable participants were of the opinion that there is a knowledge gap about the need for and benefits of HRD on SME profitability and competitiveness.

*Legal and Regulatory Barriers.* A number of implementers noted barriers to improved education and certification caused by legal restrictions that give the Ministry of Education a monopoly over certification of professional training. Upon further reflection, this gap can better be understood in two parts. First, where a central authority is needed for approving standards of education and training – such as national curriculum for primary schools – the Ministry lacks capacity to ensure that certified programs meet the needs of graduates and businesses who employ graduates. Second, there is confusion over the importance or relevance of such certification in a market economy. Businesses do not care as much about certification by a state agency as about quality of the product. At present, state certification has little to say about the quality of the certified individual, but rather about ability to meet standards that may not be relevant to business. Professional organizations can certify quality based on market standards, such as “seal of approval” programs in North America. Ministry of Education certification is important only if the program needs state approval for reasons unrelated to business need.

The legal gap described by respondents is not strictly legal, although there are legal aspects. The Ministry of Education holds a legal monopoly over certification of

formal education for purposes of receiving state funding or recognizing degrees for government programs; however, the Ministry does not currently have the capacity to set standards appropriate to the business needs of students or their employers.

In terms of administrative law, however, there is a gap leading to poor performance and quality in formal education. The current employment regulations apparently do not have any meaningful performance standards to ensure that teachers update their skills and knowledge regularly to keep up with the real needs of the market. Unfortunately, teaching seems to follow the general rule for government promotion in early transition countries: whereas private sector employers promote employees because of their performance, public sector employees are promoted in spite of their performance. There is a definite need to link performance to benefits such as salary and tenure.

*Market distortions from international donors.* SMEs in BiH have limited resources for consulting services, which means that the rates they can pay are rather low. Unfortunately for them, many if not most of the consultants in the country today are able to earn two or three times more by providing services to donors, who pay above local market rates for those services. Consequently, consultants understandably give donors first priority, reducing the supply of services available to local enterprises. At the same time, many of the services provided through projects are subsidized in order to ensure higher participation and reach target groups. As a result, local consultants who are not overpaid to provide under priced services on behalf of donors must compete against the subsidized service offerings. This appears to be having a negative impact on the development of a self-sustaining economic relationship between SMEs and service providers. Finally, many of the overpaid consultants are being trained by donors to provide project services, but not in long-term skills of how to market and promote their services once the projects end. As a result, many of these have become donor dependent, not independent, as planned. While this system may provide beneficial short-term positive impact, there is a gap in the long-term prospects for success.

*Lack of demand-driven focus in developing SME support services.* Breakout group participants identified 14 different or inter-related gaps in service delivery: 4 involved public services, 8 were based on supply, and only two focused on demand. Clearly, the donor community is supply-oriented, sometimes resulting in oversupply or disconnected supply of services to the market. Donors need to reconsider current approaches to see how they can better connect the services supplied to the services demanded by the SME sector.

*Quality certification.* It is difficult for SMEs to assess the quality of service providers before incurring the cost of training. Roundtable participants discussed the merits of certification for consultant quality – an accreditation or the market reflection of consultant performance – to reduce the risk of wasting SME resources. It was agreed that accreditation would increase SME trust in the service providers, because there is demand for relevant, quality services, not just services. With quality certified, supply would begin to meet demand, and stimulate further demand based on results. There are no quality certification projects currently planned.

## Recommendations

The complexity of reforming the HRD network to meet the needs of SMEs makes it difficult to prioritize steps, especially in light of limited funds available. Clearly, as long as the basic formal education system is neglecting needed skills and information, SMEs will continue to suffer from the unnecessary costs of re-education and basic upgrades for new entrants. Over the long term, it is essential that education be reformed from the ground up. However, there is much that can be done in the short-term by the private sector to meet its own needs, especially with donor support. Both formal and private sector educators (including consultants) could improve their capacity significantly at low cost just from sharing materials being produced by the multitude of donor training projects. From a cost/benefit standpoint, this is a very high priority for the short term that does not depend entirely on government intervention or ministry reforms.

Create an active system of information sharing. The value of a library is not in the number of books it holds, but in how often those books are used. Libraries, like the internet, are passive resources that must await use from those who need what they hold. Small libraries of donor-generated materials exist, both in hard copy and on websites. Even if combined in some way, they will only become important once there is a critical mass of people using them. BiH needs a system for capturing existing information and ensuring that it is thereafter shared. As a general rule, this will only happen if there are proper incentives in place for both aspects.

Donors can provide initial incentives for capturing information by requiring implementers to submit all materials to relevant repositories, such as industry associations, schools, municipal offices, libraries and even fellow donors. While a single donor would do well to work with a single local entity to create a central repository of all such materials, it is more important that programs require information sharing with their targeted counterparts as well as other donors. Annual conferences to review experiences – such as the recent Roundtable – should become mandatory, both between donors and among donors and stakeholders.

Incentives for schools and teachers to use information are more complicated and should be examined. Having mandatory continuing education requirements and various performance incentives would encourage teachers to update their knowledge base. To improve their pedagogical skills, they should also be required to take courses in modern approaches to teaching. Consultants will use materials that help their competitive capacity; at this point, it may be enough to provide information about how to access these materials and let the market take care of the rest, except that donors should require performance standards that include regular literature reviews and lessons learned analyses.

2. Stimulate awareness of benefits to stimulate demand. The market for education, training and consultancies depends upon the demand for such services. Demand for services, in turn, depends upon recognition that there is a need, and understanding of how services can meet that need. There is currently confusion in recognition and understanding. The Yugoslav system developed a culture of dependence in which the government was expected to define and supply all requirements to serve their controlled economic model. Today, the free market sets the standard, not the

government, and the private sector is now the primary source for meeting the needs of the competitive marketplace. Many Bosnians do not fully understand that it is now up to them to address their own problems, that they can do so, and that there are services available to make it possible. Public education campaigns addressing all these points should be conducted to:

- Enhance the sense of personal responsibility for finding solutions
- Describe solutions available and how to access them
- Demonstrate the benefits of these solutions through “success stories”

Funding should be shared with the various private sector service providers by encouraging them to advertise on their own, as well as mounting campaigns for associations who could use membership fees for promotion. Government, which has subsidized access to media, should provide information on new one-stop-shops and other government funded services. Projects should be required to develop press releases on success stories in local newspapers.

3. Establish mandatory continuing education for teachers and professors. Reforming the outdated educational system requires a long-term, comprehensive program, but there is much that can be done in the short-term that will benefit teachers, students, SMEs and the economy. The Ministry of Education should be encouraged to institute mandatory continuing education requirements for teachers of subjects related to SME development and business.<sup>67</sup> The teachers should attend at least one week each year of seminars, workshops or classes while receiving their salaries. That is, it should be part of their job description. Training could be provided with only minor adjustments by existing trainers through existing donor programs.

Politically, this may take awhile to negotiate with government and teacher unions. In the meantime, the private sector and donors can develop a separate track of teacher outreach and education. This can include inviting teachers to participate in training programs underway, developing programs specifically for teachers under existing projects, and partnering with local schools to provide seminars or special days for their students. For example, programs for the tourism cluster might involve lectures, game simulations, and e-learning opportunities for schools on the subject of customer service. Businesses and business associations can create award and recognition programs for teachers who have shown the greatest ability at teaching needed skills. Possibilities are endless, but something needs to be immediately to upgrade learning to meet the demands of the SME marketplace.

4. Rethink and revise donor programs to minimize market distortions. Two of the gaps highlighted about focus on the impact of donors on sustainability of market services. Clearly, some services fall within the acceptable parameters of subsidy that are practiced in developed countries, such as business start-up services for those who cannot afford them. However, all services must be revised to correlate closely with local market demand. This should be based on careful studies of what the market can and will support at various price and cost levels. Where possible, donors should promote competition between several service providers, always on the basis of local prices, and encourage service recipients to select among competing providers.

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<sup>67</sup> This is needed for teachers of all subjects and may need to be approached that way politically. With the importance of SME development to the immediate and future economic needs of BiH, it may be possible to accelerate a program focused on business, management, finance and vocational training courses.

5. Support establishment of meaningful quality certification. In a developed economy, it is quite appropriate to let the market determine quality. Business organizations routinely certify quality of programs, and service providers advertise high quality repeat clients as a mark of their own quality. But developed countries can afford the losses. Based on discussions at the Roundtable, BiH may need some help in creating certifications of quality so that relatively poor SMEs do not have to waste their money finding qualified service providers. One approach is for donors and their counterparts to evaluate and certify training providers based on their perceived usefulness to service recipients. Such certification is market-based, and should not be confused with government certification required for public funding. The market determines quality, not the government.

6. Develop project and industry specific interventions in parallel with comprehensive programs. While some comprehensive programs are needed to address the overall educational system, few donors are in a position to take on such a challenge. All of the above recommendations should be incorporated into existing and future programs to enhance the valuable work already being done in training and education.



## **C. Business Representation: Advocacy and Public-Private Partnerships**

A single SME has little power to affect the business environment on its own. While the owners can have an impact on how they manage costs, risks and revenues, they may have no influence on larger issues that determine the existence or overall level of costs and risks. Because of this, businesses in democracies voluntarily form associations and organization to pursue common interests by pooling their resources to achieve what none of them alone can afford to undertake.

Business associations sustain themselves by providing services to their members at a price that members find reasonable for the benefits received. These services can range from market information newsletters and networking events to training programs and legislative drafting. One of their most important functions is to engage government at various levels to ensure that the business environment meets the needs of the business community.

In developed democracies, the business sector is a key consultative partner in a wide range of public sector activity. Strategies, policies and laws are developed in collaboration with business and other social sectors to ensure that needs and interests are balanced through compromise and consensus. It is unthinkable in Austria, the Netherlands, or the United States that a single piece of business legislation could be adopted without extensive interaction with and input from the private sector. This interaction is the foundation of implementing laws by ensuring that they meet the real needs of those affected. They will also work together on local development strategies, tax regimes, administrative reforms and any other point of potential conflict between government and business needs.

The business community requires effective organizations that can facilitate participation in the policy, lawmaking and strategy processes. This allows businesses to reduce costs of unnecessary government restrictions and interventions. It also is essential in managing risks in a changing environment: businesses take part in debating the changes, so that they know ahead of time whether they will need to adjust. (In many transition countries, laws are passed with no warning or notice, often causing the collapse or severe damage to SMEs who had invested based on existing rules and conditions.) These same associations will distribute information on changes in the business environment to their members. Typically, they will also promote training, trade exhibitions, exports, investment opportunities, and other trade enhancing activities, instead of relying on the government to do this for them. This parallel pursuit of common economic goals allows government and business associations to leverage each other's resources for greater impact on the SME business environment.

### **Current Situation in BiH**

In BiH, many business associations have been created in the last few years that represent sectors, areas, and ethnic groups. At the same time, the established chambers of commerce have gone through a major shift from mandatory to voluntary membership, starting late in 2003. While this has changed their incentive structure, the extent of any change in organizational structure and management is not clear.

These organizations were designed as a part of the state-run economy, ensuring that businesses complied with government directives. Although they provided some feedback on business need, this was not based on a market economy. Consequently, they are not necessarily designed to provide market-oriented services even now. Major changes will probably be needed for the new chambers to survive.

Reportedly, existing business associations have weak structures with low levels of active involvement by the business community. There is little trust in their ability to influence government policy or belief that they can have a voice. There is still a widespread feeling in BiH that influence can only come through personal contacts, not well-reasoned arguments. As a result this is not a service that associations can offer very effectively. Worse, members express disappointment at the other services on offer as well.<sup>68</sup>

Support for business association development in BiH has been provided by several international donors, including USAID, SEED, EU, and GTZ. USAID is working with associations and chambers in wood processing, tourism and agro-industrial sectors. The aim is to improve the capacity and sustainability of independent business organizations and assist them in providing tangible services and advocacy for their members. SEED is working with select associations including the RS Employers Confederation, RS Poultry Producers Association, and Herb Growers Association in Unsko Sanski region, providing technical assistance in areas such as strategic planning, work plan development, and communications (newsletters, etc.). GTZ is working with the Automobile Association and with chambers on promotion and technical issues, including participation in international trade fairs. The EC helped establish several associations in the wood, agriculture, and textile sectors, focusing most closely on the latter two areas.

At a local level, SME involvement has been built into the development plans of Vocational Schools supported by the EU VET program and in the development of active labor market policies through pilot local offices of PAS. In at least 20 areas, SMEs are involved with partnership groups for developing and implementing local economic strategies.

The EURED program, which is creating regional development agencies, also views private sector involvement as critical. Their interventions include the creation of five economic regions, support for the development of regional development agencies (RDAs) and the provision of the EURED funds to support economic projects of regional significance. In this context, SME development is one of the key areas targeted for support. This support is provided through a number of mechanisms ranging from feasibility studies, enterprise networks, skills development, export promotion, business incubators, enterprise zones and others.

The experience of several donors suggests that SMEs are willing to actively participate in public-private partnerships when asked to do so. They have been quite involved in those of EU VET and EURED, for example, whereas many donor-funded associations are perceived as ineffective at partnering with government. The

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<sup>68</sup> OECD Enterprise Policy Performance Assessment. SME focus groups rated services from associations as poor, especially in the lack of information and advice received.

difference deserves further inquiry, but appears to depend on who is initiating the activity: SMEs are pleased to join in when government offers the opportunity, but government does not necessarily respond when proposed changes are initiated by the associations. This is not surprising in a country where government has historically been responsible for initiating and organizing any change.

## Gaps

Although many groups have been formed or supported with donor assistance, there is a question of whether this work is creating viable associations, or merely project-specific organizations that will fail when funding ceases. Levels of interaction between associations and government is also very disappointing, making membership in associations for that purpose less valuable.

*Poor association management and sustainability.* Based on discussions with interviewees and Roundtable participants, there appears to be a tendency for some project-based assistance to business associations to be focused primarily on project goals and not on membership needs. Members pay their dues when an association satisfies their reasons for joining the association, not because the association is helping with a donor project. If the association does not meet those needs, it can only survive through subsidies, because members will leave.

Unfortunately, many associations suffer from a combination of poor management and poor understanding of member desires. Specific technical assistance aimed at assisting management to understand its internal market for services, followed by execution of those services, can be very effective at creating sustainable institutions, even those with a relatively weak initial income base. Such services include information dissemination of interest to members, networking opportunities, and policy advocacy, among others. Donors should be careful in providing core funding for these major core activities, however, because they unrealistic long-term cost structures out of balance with likely income.

*Inability to respond effectively to opportunities.* Many associations that would like to participate in policy development or legislative review do not have the capacity to do so. Some do not believe they have a voice in these matters, and do not try. Others simply do not understand how, where, or when to get involved. A Croatian example is illustrative of the problem.<sup>69</sup> Several years ago, the Croatian government collaborated with the Association of NGOs to draft a new NGO law. The initial draft was a carefully developed through extensive cooperation, then sent to more than 10,000 NGOs for comment. Only 10 NGOs provided comments. They simply did not understand how to read the law or its impact on them. As follow up, the drafting group held regional meetings attended by hundreds of participants who were eager to provide input once it was clear that someone was listening and they could understand the law. In Bosnia, a more recent example involves the draft leasing law. It was sent to a number of stakeholders for comment, but none of them understood the law well enough to provide useful comments.

*Poor government understanding of how to deal with associations.* Participants at the Roundtable noted that there is no history of public-private partnership for government

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<sup>69</sup> This example is taken from "Partnering for Better Laws: A Croatian Model for Success," *News & Views, Magazine of the American Chamber of Commerce in Croatia*, No. 3, 2003.

to draw from, and thus no understanding of how to engage or respond to business associations. No one in the group could cite any donor programs underway or planned that include assistance to government officials for developing the skills and attitudes needed for public-private partnerships. Private sector efforts to create public-private dialogue will fail unless both sides of the equation receive necessary attention.

## Recommendations

In the top-down vs. bottom-up strategic dynamic, it is always important to move reforms at both ends. Without grass roots support, top-down initiatives are difficult to implement. On the other hand, unless government – which holds the power over many reforms – accepts the grass roots initiatives, bottom-up efforts will only lead to frustration. Although association management is crucial, government capacity to engage associations is a priority to ensure that associations have something useful to manage. Fortunately, both can be addressed simultaneously.

1. Create understanding and capacity among government counterparts for public-private dialogue. Most donor projects involve interaction with government and private sector counterparts. These should include components for working with government counterparts to understand why they need to interact effectively with associations and training them in the skills they will need to develop. For example, active listening, “getting to yes” negotiating styles, and customer service attitudes are not common today in BiH. It might also be advisable to work with various levels of government to help them develop effective government affairs offices as the central point of communication with the government. However, such a program would need to include training of other officials on their duties in responding to this office. Government officials should also learn how to hold public meetings for input and discussion.
2. Provide marketing and management assistance to business associations. The first priority for a business association is to meet the needs of its members. Those needs vary from association to association, so the first skill needed for the managers is marketing so that they can understand that their members want and provide it to them effectively. In addition, many associations need substantial assistance in learning basic office, personnel and business management skills. These services can be provided through stand-alone projects focusing on business association development (such as the current USAID CIPE project), or woven into the tasks involving associations.
3. Develop capacity for policy interventions by associations. For associations that want to offer advocacy services, it will first be necessary to develop a number of advocacy skills. These include policy development, policy advocacy, cost-benefit analysis, and legislative interpretation and drafting. If possible, law schools should be involved in some aspect of skills development, because they often have professors who hold virtual monopolies over the legislative drafting process. Unfortunately, few of them have any practical experience in the impact of the laws they draft, so it is important to open communication between them and those who understand how things actually work. The program should also provide information on all of the local legislative and administrative processes, showing who the decision makers are, when and how to provide input into the process, and how to contact those who should listen.

On a strategy level, one of the lowest cost, most effective approaches available in the short-term is simply to increase the level of counterpart participation in the planning and implementation process of existing and future projects. Numerous Roundtable participants identified this as a serious gap in existing programs.

## D. Business Improvement and Expansion: Cluster Development and Linkages

In the past decade, Michael Porter has demonstrated conclusively that competitiveness is not just an issue for individual firms, but for nations as well. In his seminal work on the *Competitive Advantage of Nations*, Porter establishes the impact of a variety of stakeholders and economic actors in creating overall competitive capacity to produce products that can compete with products from another country or region. In *Plowing the Sea*, Michael Fairbanks and Stace Lindsay developed his themes on a practical basis, by comparing the composite costs of an export between countries to demonstrate their impact on final prices, and thus on export competitiveness. More simply put, when interconnected stakeholders work together to lower component costs, a country's exports become more competitive. Even more simply, these clusters reduce the costs of production so that businesses can earn more in a competitive environment.

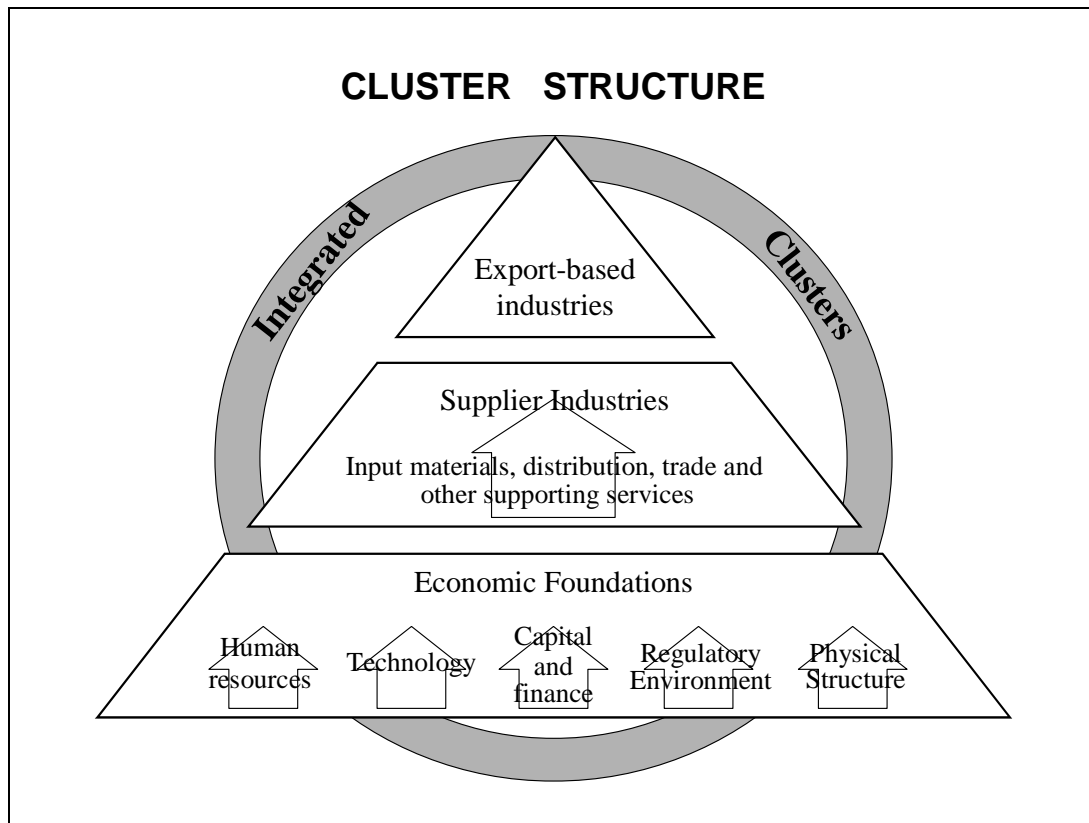
This is important for SMEs, because they constitute the vast majority of enterprises involved in the interlinked network that produces the export goods. It has been shown that healthy clusters of connected businesses have very high positive impact on economic development and competitive excellence of the region where they are located. Because they potentially involve dozens or hundreds of firms across various sectors, cluster development can have a tremendous impact on SMEs.

Industry clusters can be defined as agglomerations of firms in similar or related fields that grow within or are attracted to a region/nation<sup>70</sup>; linkages are a productive connection between two or more organizations.<sup>71</sup> These occur naturally at times along the business value chain, as vertical and horizontal links in the chain achieve cost reductions and consequent revenues that in turn support greater development of that cluster. When the market fails to produce clusters, for whatever reasons, they can sometimes be stimulated through appropriate government intervention.

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<sup>70</sup> Cluster Competitiveness Initiative Stage I Report, USAID October 2002.

<sup>71</sup> SME Gap Analysis, Business Improvement and Expansion—clusters and linkages breakout group, April 2004.



Competitive advantage is not created within a single firm alone. Efficiency in internal operations is a necessary, but export producer or service providers depend on costs charged by others in the value and distribution chain to attain a competitive price in the global market. Cost factors include: skilled and adaptable human resources; cost of finance for export or investment; transportation (including road quality); communications; taxes; utilities and waste services; environmental regulations; facilities; technology; market information; and even quality of life. Thus a raspberry exporter must deal with costs of land, fertilizers (if any), packaging, overall overhead costs for operations, interest on loans, local taxes, export taxes, customs delays, brand recognition, and a host of others that combine to create a per unit price. Whenever significant costs are lowered, the price can also be lowered. As a result, improvements in customs clearance and better farm management will both have a positive impact, but only one is directly within the control of the producer.

A cluster approach creates mutually beneficial linkages both horizontally and vertically within the value chain. Competitive businesses require a skilled work force with expertise in marketing, finance and in other business subjects. Within the cluster model, businesses can open meaningful dialogue with university officials and other educational bodies to create synergies that result in a more competitive workforce. Collectively, they can offer a market that helps encourage the development of specialist service providers with services tailored to their specific needs

With new free trade agreements recently going into effect, BiH businesses will find it even more difficult to compete against neighboring countries. Meanwhile, neighboring countries (Slovenia, Croatia and Serbia) have all established cluster initiatives that are intended to create a more competitive business environment in their respective countries by forming a partnership among all elements of the value chain.

Unless a more competitive atmosphere can be similarly created in BiH, businesses can expect to find it even more difficult to compete against imports or expand their exports.

## Current Situation in BiH

A great deal of work has been undertaken to assist established SMEs develop their business performance because individual firm performance is crucial to sustainable growth. SEED has worked directly with a growing number of companies on “Internal Enhancement Plans” sometimes linked to raising investment. DFID and EU have organized interventions with over 55 recently privatized companies. Cluster development has provided a vehicle to overcome the lack of coordination between players: businesses, donors, government, schools and other.

The new management skills and organizational restructuring required by the transition to a market economy mean that there is an ongoing requirement for holistic approaches to individual firm development that can be met by individual commercial consultancy activity. While further development of local management consultancy supply is required, a great deal of local experience now exists. The key issue is reinforcing awareness of the need for such individual services within a growing number of established companies and not launching new initiatives that might undermine commercial viability of local supply. Thus programs subsidizing consultants selected by the SMEs rather than providing direct subsidized services are more likely to encourage growth of the existing market.

Recently, some donors have started to develop their assistance to include cluster promotion and linkages more explicitly. Many projects have encountered market breaks affecting the trading environment of local counterparts. As a result, a number of donors have designed and implemented to assist individual SMEs with starting cluster and linkage activity as a necessary part of helping these stakeholders achieve profitability. For example, DfID is working with a food processor in a pilot project to develop the local supply chain from small producers..

Cluster development is generally an unfamiliar concept to many businesses, associations and government bodies. Many do not trust their counterparts and are reluctant to work with them, even for their common interests, in part because so much competition is carried out through use of political connections instead of market skills. Research bodies do not understand the potential for cooperation with SMEs for mutually beneficial research and development activity, but instead look always to government to support research and development activity. Consequently, many firms, associations and institutions often act in isolation and, therefore, are unable to tackle these barriers to effective business.

Meanwhile, SMEs continue to contend with a daunting environment that inhibits the growth of the private sector. Regulations are often excessive, confusing and ill suited to a market economy. Interaction between government and business is generally adversarial. Businesses view government more often as an obstacle rather than an ally, while government appears to view the business community as an opportunity for quick financial gain. Indeed, some respondents stated that officials try to tax start-up companies quickly, before they go out of business.



The Bulldozer Committee has generated interest within the business community as a mechanism for holding government accountable for excessive regulations. However, it does not provide a forum for businesses, government and universities to collaborate in developing strategic initiatives for a more competitive business environment.

Some natural and donor-sponsored cluster advancement has occurred with associations. Members of the business community have formed a number of business associations to represent their interests, usually based on a business sector (poultry, fruit and vegetable, wood, etc.). However, members of an association are typically confined to firms within a particular sector, and do not include other actors in the value chain (for example, the wood association may not have any banks or log transporters as members).

Direct donor assistance for cluster development has expanded in recent years. For example, GTZ has recently expanded its assistance to include cluster development in such sectors as wood, automotive components, metal, textiles and shoes/leather. USAID is planning full-blown cluster development assistance to three sectors: wood processing, tourism and agriculture.

Other donors, such as SEED, are more focused on supply-side management and retail distribution assistance to selective sectors. The World Bank and USAID are also assisting the agriculture sector in different regions to link producers and processors to the markets.

EURED is taking a related approach by supporting the development of regional development strategies. Five regional development agencies are being established based on geographical coverage, and together they cover the entire BiH. The program will support a number of local and regional pilot projects to support SMEs, but are unlikely to be able to effectively address linkage and cluster issues because of their restricted geographical area

## Gaps

Cluster methodology is an area beset by poor understanding and differing definitions. This was apparent at the Roundtable, when implementers began their break-out group discussion on this topic by first making sure that they were all using the word “cluster” in the same way. Definition of the concept, however, is not as important as understanding the economic impact of interplay among the various stakeholders within a cluster. This has led to isolation of the players – one group simply does not understand the impact or importance of the others and thus does not take advantage of resources and opportunities available. This is exacerbated by lack of trust among the stakeholders, so that even if they do understand the possibilities, they are hesitant to act in necessary collaboration to achieve more. Together, these undermine the ability of stakeholders to connect for specific issues such as market-oriented research. The gaps below follow this logic, as set by the Roundtable participants.

*Isolation of the Players:* Universities do not understand what skills people need to be successful in a market driven environment (nor do they seem to think that it is necessary to find out!). Governments at all levels do not understand that they need to enable businesses to thrive, not hamper their ability to operate and compete. Businesses do not share experiences, lessons learned, or other useful information

through business associations. As a result, basic understanding needed for developing linkages and clusters is lacking.

*Lack of Trust:* Establishing linkages among different elements of the value chain can be very challenging in BiH. Local leadership and a willingness to collaborate are sometimes lacking among businesses, associations and government officials. In some cases, participants must overcome traditional adversarial relationships. It needs to be clearly recognized that businesses engage in cluster development activity in order to increase profitability. Some of this resistance to collaboration appears to come from economic misunderstandings and ignorance: there is a prevalent belief that success is a zero-sum game in which one person's advance can only come at another's loss. In addition, there is a problem with negative envy throughout the Balkan Peninsula in which it is considered better to forego an opportunity for your own benefit if it will also benefit others.<sup>72</sup> This is currently exacerbated by hard feelings from the war which stand in the way of inter-ethnic cooperation.

*Poor connection between business and research.* It is not enough for long-term success that clusters improve their presence in existing markets, which are already highly competitive for Bosnia products. They need to focus as well on niche markets based on good market research. For example, Croatia currently has a cluster program with strong government support for developing their wood processing industry. It may therefore be more profitable for Bosnia first to study Croatia's market strategy and pursue a different niche, unless it is clear that Bosnian producers can out-compete Croatia. Unfortunately, local market and scientific research and development institutions are often managed in an environment that is disconnected from the demands of the marketplace. Establishing collaborative relationships with R&D institutions will be critical for both individual enterprises and clusters to develop new niche markets and value added products.

*Lack of understanding of the benefits of cluster participation.* Roundtable participants started the breakout session by seeking to define a common definition of clusters, having noticed that many seemed to be using it in different ways. If the donors are confused, it is not surprising that the public does not understand the concept. The term, concepts and approach need to be clearly defined in a Bosnian context. Understanding of how clusters can begin – with or without donor assistance – appears to be limited to the donor community and their counterparts. It needs to expand to a larger audience.

## Recommendations

1. Reduce isolation and improve understanding. Isolation and poor understanding go hand in hand, and undermine the rate of change and likelihood of success. Public awareness campaigns are needed with each cluster project to explain the concepts through media as well as multi-sectoral events that bring together businesses, support providers, RDAs, schools, universities, governments and donors for debates, discussions, and even lectures. Macedonia has been very successful in creating understanding through an aggressive public education campaign including everything from posters and television shows to high profile

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<sup>72</sup> There is a popular joke that captures the concept in which a peasant is granted a wish. After thinking about his situation and comparing it to his neighbor's greater wealth, he does not ask for anything more for himself, but instead wishes for his neighbor's destruction.

cluster trade fairs. The campaign concentrates on benefits while explaining how the cluster approach works so that other industries can apply the methodology themselves.

2. Understand and reduce barriers to trust. Establishing trust is not simple, in great part because trust can never be mandated, it can only be earned. Where trust is missing, the reasons are usually quite specific, and those reasons must be addressed to re-establish trust. This is a “soft” target with hard impact, because barriers caused by distrust inhibit creation of the relationships needed to establish clusters or other cooperative arrangements. Consequently, it is necessary to address the problem, first by conducting comprehensive surveys to understand the reasons why trust has broken down. Only then will it be possible to promote understanding and changed behavior necessary to restore or create necessary relationships.

3. Broaden the use of cluster methodology. While cluster methodology is not a panacea, it does provide very instructive analysis for understanding the multiple levels of a problem. It also allows for reaggregation in areas where donors have disaggregated a complex problem in order to address each component. For example, a cluster analysis of the secured transactions environment would generate understanding of the multiple laws involved in a pledge registry project, and the number of stakeholders who must be included to make the changes effective. Related training, for example, would include not only registrars, but banks, leasing companies, business associations, consumer organizations, judges, lawyers, notaries, clerks, enforcement agents, auctioneers, appraisers, business journalists, MCOs, and law professors. The cluster approach is comprehensive, allowing deliberate choices of who is or is not included in the final project.

## List of Acronyms

ABA/CEELI.....	American Bar Association/Central Eastern European Legal Initiative
ATMs .....	automated teller machines
BAC .....	business environment adjustment credit
BDS.....	business development services
BF.....	USAID Business Finance Project
BiH.....	Bosnia and Herzegovina
CAFAO .....	Customs and Fiscal Assistance Office
CCA .....	Cluster Competitiveness Activity
CGBIP.....	Corporate Governance and Business Investment project (USAID)
CHF.....	Cooperative Housing Foundation
CIPE.....	The Center for International Private Enterprise
CIT .....	communication and information technology
DCA .....	Development Credit Authority
DEZA.....	Direktion für Entwicklung und Zusammenarbeit (Swiss Agency for Development and Cooperation)
DFID .....	Department for International Development (UK)
EBRD.....	European Bank Reconstruction and Development
QIF .....	Quick Impact Facility (EU)
EU RED .....	European Union Regional Economic Development
VET.....	Vocation Education and Training (EU)
EU .....	European Union
EUPER.....	European Union Programme of Enterprise Restructuring
FIAS.....	Foreign Investment Advisory Service
FILE .....	Fostering and Investment and Lender-Friendly Environment project (USAID)
FIPA.....	Foreign Investment Promotion Agency
FSBAT .....	Financial Sector Business Advocacy project (USAID)
FSVC.....	Financial Services Volunteer Corps
GTZ.....	Deutschen Gesellschaft für Technische Zusammenarbeit
HRD .....	human resources development
IFC .....	International Finance Corporation
IGA .....	Investment Guaranty Agency
IT.....	information technology
KFW.....	Kreditanstalt für Wiederaufbau
KM .....	Konvertibilna Marka - Convertible Mark (BiH currency)
LAMP .....	Linking Markets and Agricultural Producers
LESP.net .....	Local Economic Service Providers network
MBA .....	Masters of Business Administration

MCO .....Micro Credit Organization  
 OECD.....Organization for Economic Co-Operation and Development  
 OHR .....Office of the High Representative  
 OSCE .....Organization for Security and Cooperation in Europe  
 OSF .....Open Society Foundation  
 PAS .....National Employment Agency  
 PPERP.....Post-privatization and Enterprise Restructuring Programme (DfiD)  
 R&D.....research and development  
 RDAs.....Regional Development Agencies  
 RS.....Republika Srpska  
 SEED.....Southeast Europe Enterprise Development  
 SiDA .....Swedish International Development Agency  
 SME .....small and medium sized enterprises  
 UD.....University of Delaware  
 USAID .....United States Agency for  
 VAT .....value added tax  
 WB .....World Bank

## List of Roundtable Participants

Organizations	Participants
1. BiH Council of Ministers (PRSP)	1. Zlatko Hurtic, Coordinator; 2. Haris Mešinović, Assistant Coordinator.
2. BiH Ministry of Foreign Trade and Economic Relations	3. Ivica Miodrag, Head of Department for SME Development and Promotion.
3. Bosnia–Drina Development Foundation	4. Ismet Hatibovic, President of the Steering Board.
4. Business Service Center (Ze-Do Canton)	5. Salih Alispahic, Inspections and Bus. Registration; 6. Valida Imamovic.
5. Department for International Development (DFID)	7. Ruvejda Hadzihrustic, Program Manager. Implementers: 8. John Hansen, Project Manager—Reform of Business Registration; 9. Natasa Miskin-Vucetic, Local Project Director, Reform of Business Registration; 10. Ian Robertson, Enterprise Restructuring; 11. Milford Bateman, Enterprise Restructuring; 12. Zoran A. Pavlovic, Project Director, Enterprise Restructuring.
6. Embassy of Britain	13. Mary Shockledge, Head of DFID Office.
7. Embassy of Japan	14. Hiroyuki Kawamoto, Third Secretary; 15. Noriko Takahashi, Project Formulation Advisor JICA Austria Office.
8. European Bank for Reconstruction and Development (EBRD)	16. Zahida Karic, Associate Banker; 17. Charlotte Gray, SME Specialist.
9. European Union	18. Mark Priestley, Task Manager; 19. Jadranka Ruvic, Task Manager Vocational Training 20. Meliha Kozaric-Fanning, Regional Advisor, EU RED; 21. Sladjana Simic, Communication Advisor, EU RED; 22. Tanja Zabukovec, Regional Development Advisor, EU RED; 23. Harry Govan, Fund Manager; EU QIF; 24. John Wallace, Senior Economic Advisor; EU QIF; 25. Adrian Marshall, EU QIF; 26. Elizabeth Hughes, EU Housing Verification Monitoring Unit.
10. Federal Ministry of Development, Entrepreneurship and Craft	27. Mladen Cabrilo, Minister; 28. Jozo Bejic, Secretary; 29. Franjo Galic, Assistant Minister.
11. Foreign Investment Advisor Service (FIAS)	30. Margo Thomas, Task Manager-BiH
12. Foreign Investment Promotion Agency (FIPA)	31. Mirza Hajric, Director; 32. Maida Becirevic, Legal Advisor; 33. Selma Uzicanin, Head of the Office for Research and Development.

13. German Development Cooperation (GTZ)	34. Andreas Clausing, GTZ Representative; 35. Ute Dannenmann, Economic Development; 36. Wulf Goretzky, Team Leader, Private Sector and Employment Promotion; 37. Roland von Frankenhurst, Harmonization of the Tax System; 38. Jean-Luc Horisberger, Team Leader of the Land Registry Project; 39. Dr. Ulrich Solte, Advisor for Economic Law Reform; 40. Rainer Mueller, Insurance Advisor; 41. Fahrudin Gvozdar, Coordinator.
14. International Monetary Fund (IMF)	42. Berina Selimovic, Economic Advisor.
15. KFW Office Bosnia and Herzegovina	43. Aida Soko, Head of European Fund; 44. Jasminka Muslic, Risk Manager.
16. Office of the High Representative	45. Donald Hays, Principal Deputy High Representative; 46. Benjamin Lawrence, Junior Economic Advisor; 47. Gerold N. Larson, Deputy Head; 48. Laila Hermas, Social Affairs, Economic Advisor.
17. OHR Bulldozer Committee	49. Richard P.T. Ots, Senior Advisor; 50. Vedad Ramljak, Business Reform Officer.
18. RS Ministry of Energy and Industry	51. Ljubo Glamocic, SME Coordinator.
19. RS Ministry of Economic Relations and Coordination	52. Natasa Zrilic, Assistant to Assistant Minister.
20. The World Bank	53. Goran Tinjic, Operations Analyst; 54. Tarik Sahovic, Program Analyst; 55. Vladimir Kreacic, BAC Team Leader (Zagreb hqrt.); 56. Mirzet Ribic, Executive Director, Micro Finance;
21. SME GAP Analysis Roundtable Team	57. Drew Lent, Facilitator; 58. Wade Channel, Consultant; 59. Ann Richards, Consultant; 60. Peter Milford, Consultant; 61. Boris Divjak, Consultant.
22. Southeast Europe Enterprise Development (SEED)	62. Alexander Paine, Investment Officer; 63. Lejla Dragnic, Program Manager; 64. Lada Busevac, Platform Leader for Administrative Dispute Resolution; 65. Ivana Curic, Platform Leader for Business Association; 66. Azra Delalic, Project Manager for One-Stop-Shop; 67. Tamir Mostarac, Platform Leader for Housing Finance; 68. Adnan Mededovic, Platform Leader for Linkages; 69. Denis Obarcanin, Platform Leader for Leasing; 70. Benjamin Reno Weber, Impact Assessment Operational Analyst.
23. Swedish International Development Cooperation Agency (SIDA)	71. Nedim Bukvic, Program Officer. Implementers: 72. Richard Reynolds, Technical Advisor to EKI; 73. Sadina Bina, EKI General Manager; 74. Sue Birchmore, World Vision Bosnia Director; 75. Lamija Kozaric-Rahman, IGA Director; 76. Edin Hadzimusic, IGA Credit Analyst; 77. Amela Malicbegovic, CHF, Director of Regional

	Economic Agency.
24. Swiss Agency for Development and Cooperation DEZA	78. Rene Holenstein, Country Director; 79. Kristina Milosevic, National Program Officer; 80. Snjezana Brkic, Economist.
25. UNDP	81. Richard Marshall, Poverty Reduction and MDG Specialist; 82. Armin Sirco, SME Coordinator; 83. Goran Vukmir, Liaison Officer, Banja Luka Office.
26. United States Agency for International Development—BiH	84. Howard Sumka, Mission Director; 85. John Seong, Director, ERO; 86. Vlado Milin, Banja Luka Program Manager; 87. Amy Meyer, Program Officer, ERO; 88. Steve Meyer, Short Term PSC, ERO; 89. Caroline Brearley, Project Development Officer, ERO; 90. Dzenana Fazlic, Program Dev. Assistant, ERO; 91. Dina Karic, Financial Analyst, ERO; 92. William Lawrence, Senior Private Sector Advisor, ERO; 93. Emir Mehmedbasic, Project Management Specialist, ERO; 94. Dobrila Vukmanovic, Program. Dev. Assistant, ERO; 95. Marinko Sakic, Project Management Assistant.
27. United States Agency for International Development – Washington, DC	96. Sarah Farnsworth; The Balkan Desk, E&E; 97. David Jessee, Chief, Market Transition Division.
28. United States Embassy	98. Clifford J. Bond, Ambassador; 99. Chever X. Voltmer, Economic Counselor; 100. Heather Noss, Economic Counselor.
29. United States State Department – Washington, DC	101. Melissa Janis, Program Officer, Bosnia; 102. Eric Meyer, Acting Treasury Representative for European Affairs;
30. USAID—Bank Supervision	103. Dale Wilson, Chief of Party; 104. Vildana Tuzovic.
31. USAID—Graduate Business Education Project (BIZED)	105. John Stocker, Deputy Chief of Party.
32. USAID—Business Finance (BF)	106. Stephen F. Farkas, Chief of Party; 107. Naida Trkic.
33. USAID—Corporate Governance and Business Investment Project (CGBIP)	108. Robert A. Moore, Chief of Party; 109. Snjezana Derviskadic, Senior Consultant, Tourism; 110. Matko Stjepanovic, Senior Consultant, Wood; 111. Jasmina Ahmetbasic, Senior Consultant; 112. Sanin Džananovic, Financial Manager.
34. USAID—Center for International Private Enterprise (CIPE)	113. Dana Southworth, Chief of Party; 114. Vivek Date, Business Association Expert.
35. USAID—Fostering an Investment and Lender Friendly Environment (FILE)	115. Pat Wujick, Chief of Party; 116. Craig Benson, Collateral Specialist; 117. James Regan, Bankruptcy Attorney; 118. Fedjad Zaciragic, Bankruptcy Law Specialist; 119. Mihridzana Muratbegovic Collateral Law Specialist.
36. USAID—Financial Sector Business Advocacy and Training Project (FSBAT)	120. Kent McNeil, Chief of Party; 121. Steve Butler, Real Estate Analysis;



	122. Monica Montoya, MCO Consultant; 123. Jusuf Tanovic; 124. Goran Stefatic.
37. USAID—Financial Services Volunteer Corps (FSVC)	125. Almir Jazvin, BiH Manager; 126. Boris Duras, Guest Expert, Zagreb Office.
38. USAID—Global Trade Technical Network (GTN)	127. Dzevad Sehic, Chief of Party.
39. USAID—Linking Agricultural Markets to Producers (LAMP)	128. Brian Fahey, Chief of Party; 129. Maja Berbic; 130. Tom Thompson, Deputy Chief of Party; 131. Armin Kloeckner, Policy Advisor; 132. Sabaheta Cutuk, Policy-Agribusiness Advisor.
40. USAID—Pledge Registry Project (PRP)	133. Yair Baranes, Chief of Party; 134. Boris Maslo, Attorney at Law; 135. Maja Bosnic; 136. Ioannis Armakolas, Consultant.
41. USAID—PSARP (Private Sector Accounting Reform Project)	137. Liam Coughlan, Chief of Party;
42. USAID—Tax Administration Modernization Project (TAMP)	138. Sam Greer, Chief of Party; 139. Mark Gallagher, Tax Analysis.
43. USAID-Local Government Support Activity	140. Dean Fu, Process Engineer.
44. US Treasury Department	141. Anne Schwartz, Resident Advisor; 142. Darlene Berthod, Resident Advisor.
45. VB Leasing	143. Lidija Jankovic, Executive Manager.

The 143 participants represented 45 organizations. Given the size of USAID's presence in BiH it is not surprising that USAID constituted the largest participant block (52 people including 12 staff, 38 contractors and 2 from USAID/W). Regardless this presence only accounted for a third of the participants. Next to USAID, the largest donor representation came from SEED (9), EU (9), GTZ (8), DFID (6), SIDA (7) and the WB (staff and project = 4). The remaining forty-eight participants included other donors, BiH government technical staff and regional development agencies as well as two technical staff came from outside of BiH.

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## **Government and Business Feedback**